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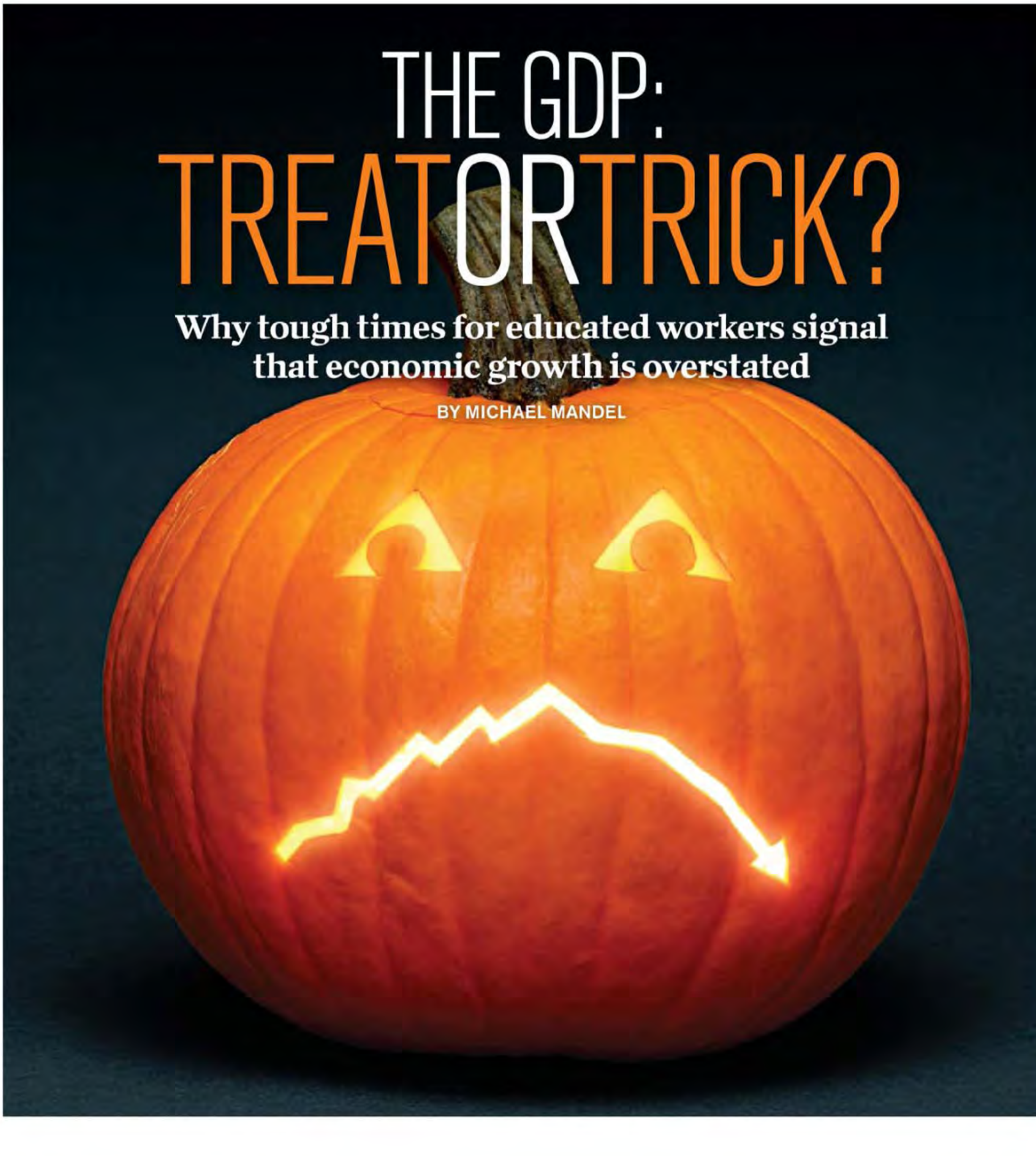
BANKING'S CIRCLE OF DEATH | BIG RISK IN VEGAS

# BusinessWeek

# THE GDP: TREAT OR TRICK?

**Why tough times for educated workers signal that economic growth is overstated**

BY MICHAEL MANDEL






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*Per Gartner Group Vice President Neil MacDonald, as quoted in: McLaughlin, Laurianne; "How to Find and Fix 10 Real Security Threats on Your Virtual Servers," CIO Magazine, 14 November 2007, www.cio.com/article/print/154950
**Per Gartner Group Vice President Neil MacDonald, as quoted in: "Gartner: Rush to Virtualization Can Weaken Security," On-Demand Enterprise, 09 April 2007,
http://www.on-demandenterprise.com/offthewire/gartner_rush_to_virtualization_can_weaken_security_07-29-2008_08_52_18.html



88% of North American companies don't have a virtualization security strategy
60% OF PRODUCTION VIRTUAL MACHINES ARE LESS SECURE THAN THEIR PHYSICAL COUNTERPARTS.*
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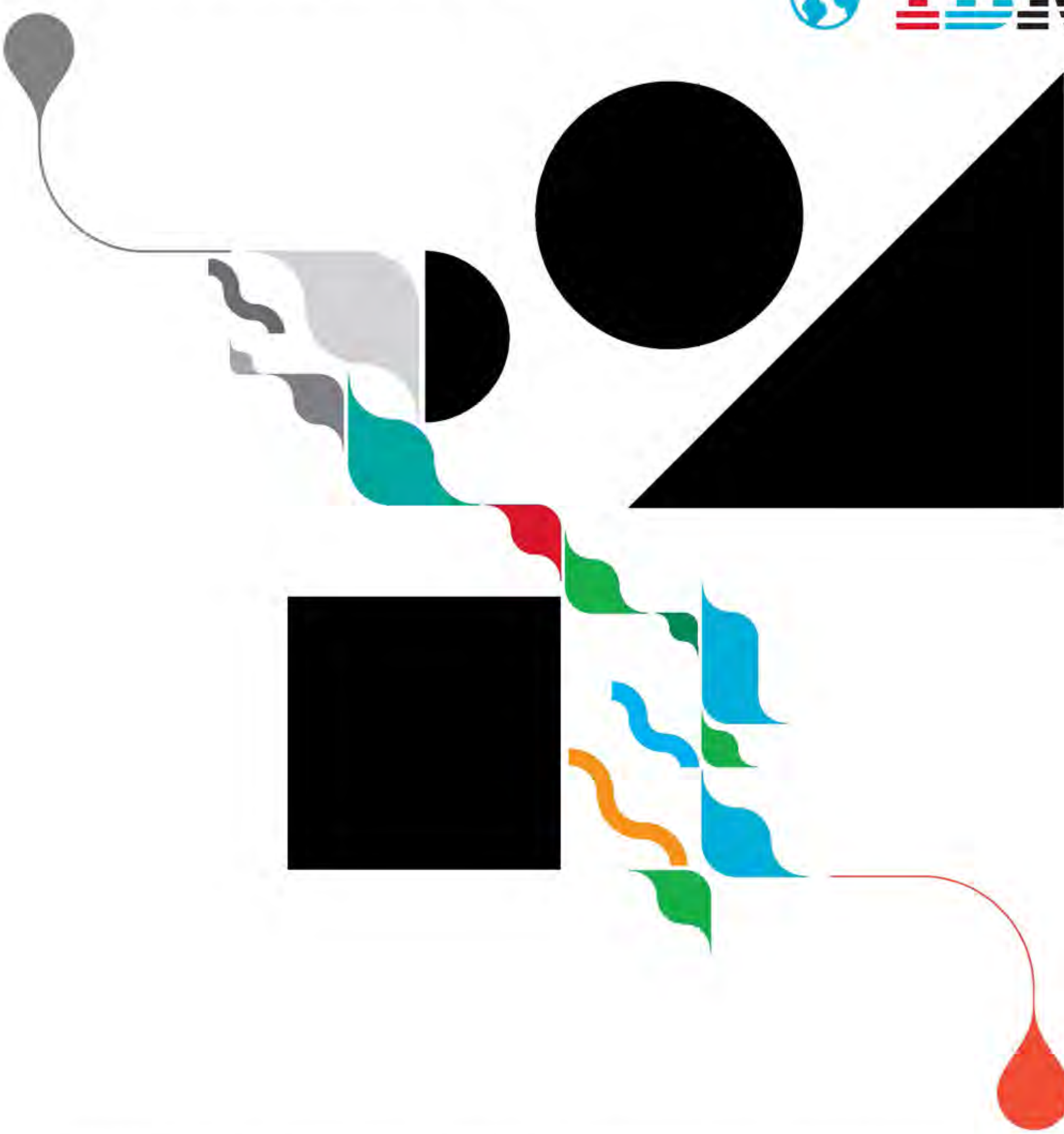
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# Is it possible to build a supply chain that delivers intelligence?

The opportunities of an interconnected world come with a host of challenges for today's supply chains: rapid wage inflation, spikes in commodity prices, unpredictable currency rates. Transportation costs alone can fluctuate by as much as 250% per year. IBM helps companies manage cost volatility by building flexibility into supply chains—interconnecting everything from customers to suppliers to IT systems. Allowing businesses to shift workloads around the globe, adjust inventory based on changing demand and respond to currency fluctuations by realigning global partnerships. This kind of flexibility is helping companies in industries as diverse as healthcare, retail and electronics adapt to market changes and cut costs. In fact, last year, IBM helped build flexibility into 17 of the world's top 25 supply chains.[1]

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IN DEPTH

## BANKING: MEET MR. CLEANUP

040 | Small-town bankers like Jim Edwards, CEO of United Bank in Griffin, Ga., are building their businesses by acquiring failed rivals at bargain prices. They're also doing federal regulators a big favor by helping to mop up the nation's banking mess. |BW|

MANDEL ON ECONOMICS

## THE GDP MIRAGE

034 | The most comprehensive gauge of U.S. economic activity is broken. By overlooking reductions in research and development, product design, and worker training, the gross domestic product numbers greatly overstate the economy's growth. |BW|

## IT'S A BIRD, IT'S A PLANE, IT'S PORK!

046 | Boeing's C-17 Globemaster cargo aircraft cost the government $250 million apiece. The Pentagon says it has all the planes it needs, and the Obama Administration wants to rein in military spending. But it's nearly impossible to kill a project that provides jobs in 43 states. |BW|

Accidental hero: Jim Chambers, CEO of United Bank in Georgia

(COVER) PHOTOGRAPH BY ADAM LEVEY; PUMPKIN CARVED BY BIRTE VON CAMPEN; (THIS PAGE) PHOTO ILLUSTRATION BY SEAN MCCABE FROM A PHOTOGRAPH BY ANN STATES



## THE BIGGEST GAMBLE IN SIN CITY

MGM Mirage CEO Jim Murren says the company's colossal CityCenter resort will draw a new breed of tourist to Vegas. Maybe. But the development might be overkill in an overbuilt market—and MGM could be the biggest loser. | BW | PAGE 056



## THE RACE TO SAVE CHRYSLER

Fiat CEO Sergio Marchionne plans to plug product holes with the Italian company's cars. But there's a hitch: Chrysler could stall out before he can deliver the goods. | BW | PAGE 022

STEPHEN VOSS; ILLUSTRATION BY PHILIP BURKE


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TODAY
Thinking green
TOMORROW
Planning for blue
TOYOTA
toyota.com/future
Can today's environmental thinking inspire tomorrow's technology? Toyota believes so. Since its launch, the Prius has earned the love of millions of forward-thinking drivers. We estimate our hybrid technology has saved a billion gallons of gas and lowered $CO_2$ emissions by billions of pounds.* It's also paving the way for the next generation of environmental vehicles. Like cars charged at home. Or cars that will run solely on electricity, or consume hydrogen and emit only water. Because when it comes to thinking green, the sky's the limit.
*Estimated savings compares each U.S. hybrid vehicle's EPA combined mpg rating with its segment average based on latest EPA Trends Report (driven 15,000 miles annually). Actual mileage will vary. ©2009

# THE BUSINESS WEEK

EDITED BY HARRY MAURER & CRISTINA LINDBLAD



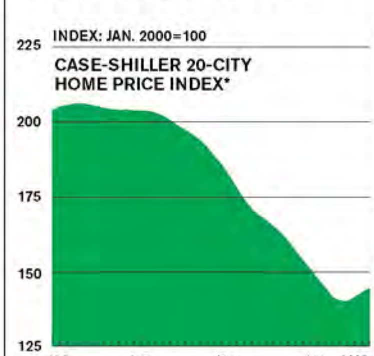
Reid surprised Washington by putting the public option back in the spotlight

## ECONOMICS & POLICY

### HEALTH-CARE ABOUT-FACE

Just when it seemed to be left for dead, he brought out the defibrillators. **Senate Majority Leader Harry Reid** (D-Nev.) shook up Washington on Oct. 26 with an announcement that health reform legislation must include a government-funded insurer, the so-called public option, days after the **Finance Committee** issued a bill without any such plan. Reid's stance placated liberals but angered lots of others. He admitted he would need all 58 Democratic senators and two Independents to immunize the bill against a filibuster, since no Republicans back a public plan. And rounding up 60 votes doesn't seem likely. Independent **Senator Joseph Lieberman** of Connecticut immediately said he would join with the GOP to fight a public plan, and at least three moderate Democrats have expressed reservations. The drama now shifts to the House, where members say their version of health reform could move to the floor in early November.

**FOUNDATION FOR RECOVERY?**




Data: Standard & Poor's *Seasonally adjusted

### HOUSING ON THE MEND

Home prices continue to inch up the stairs from the basement. In August, for the third month in a row, the **Standard & Poor's/ Case-Shiller** 20-City Home Price index improved, and it now stands 3% higher than its May low—though it's still 30% below its peak in May 2006.



Peltz will push for changes at money manager Legg Mason

(TOP) CHIP SOMODEVILLA/GETTY IMAGES; (RIGHT) EVAN AGOSTINI/GETTY IMAGES

Sales numbers in September, on the other hand, weren't so stellar. The **National Association of Realtors** said that existing-home sales reached their highest level since July 2007, rising by 9.2% from a year earlier. But sales of new homes were surprisingly slow, down 7.8% from last September, said the **Census Bureau** and the **Housing & Urban Development Dept.** Meanwhile, consumer confidence, after dipping in September, slid further in October, with the **Conference Board's** index falling 5.7 points, to 47.7. While the index remains 89% above its February bottom, it has essentially stalled over the past five months.

**| BW | PAGE 016 "A Housing Recovery with a Solid Foundation"**

**TOO BIG TO FAIL?**

Call it the **AIG** problem: How to prevent huge and complex financial institutions from holding the taxpayer hostage when they begin to totter. The **Treasury** and **Representative Barney Frank** (D-Mass.), the powerful chairman of the **House Financial Services Committee,** on Oct. 27 unveiled legislation that would give the Fed and other regulators the authority to keep close tabs on potentially dangerous firms and dismantle them quickly and cleanly if they fail. The bill proposes that financial houses with more than $10 billion in assets share the cost of doing so. Although wrangling over the details is certain—some lawmakers balk at giving the Fed much more power—industry has broadly backed the concepts, and Congress is desperate to show progress in addressing the causes of the meltdown.



## FINANCE

**A GIANT BANK SHRINKS**

**ING Group,** saved by $14.9 billion in bailout cash last year, is being cut down to size. Under pressure from the European Union, the once-mighty global player will shrink into something closer to a regional Benelux bank. ING said on Oct. 26 that it would split off its insurance business, including **ING Direct USA,** from its banking unit. ING will also raise $12 billion to pay back bailout money. The bank figures its balance sheet will shrink to 45% of its $2 trillion peak by 2013. The news pummeled ING's stock, which fell 18% on Oct. 26. That dragged down the shares of other bailed-out banks such as Britain's **RBS** and **Lloyds Banking Group** on speculation that they, too, could be nudged to break up.

**PELTZ COMES CALLING**

Diamonds. Hamburgers. Ketchup. What do they have in common? They've all drawn intense interest from



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activist investor **Nelson Peltz,** who bought stakes and pushed for change at **Tiffany, Wendy's,** and **H.J. Heinz,** among other companies. Now Peltz has a new target, money manager **Legg Mason,** whose mutual funds performed disastrously during the downturn, causing customers to decamp. Peltz started buying shares heavily this summer through his hedge fund, **Trian Fund Management,** and having accumulated a 4.3% stake, he demanded and won a board seat. In exchange, Peltz agreed not to buy more than 9.9% of the company.

### MORE GALLEON FALLOUT

The charges of insider trading at **Galleon Group** have touched another prominent business figure: **Hector Ruiz,** former CEO of **Advanced Micro Devices.** On Oct. 27, *The Wall Street Journal* reported that Ruiz is the executive who federal authorities say tipped off **Danielle Chiesi** about the timing and structure of last year's massive reorganization of AMD. Chiesi, who worked at **New Castle Funds,** is one of six people facing charges in the Galleon matter. Ruiz, who has not been charged and declined to comment, is now chairman of **GlobalFoundries,** the chip manufacturer that AMD spun off with help from Abu Dhabi's investment arm.

**"AMD Exec's Loose Lips Help Sink Galleon"**
**businessweek.com/magazine**

## STRATEGY

### AIG, MEET 'AIG TWO'

Insuring well may be the best revenge for **Maurice "Hank" Greenberg,** former CEO of AIG.



Greenberg's C.V. Starr seems to be modeled after the insurance giant he built, AIG

Greenberg was bounced after an accounting scandal but is still AIG's top shareholder after the U.S. government. On Oct. 27, *The New York Times* described Greenberg's efforts to build his new company, **C.V. Starr,** into a complex web of insurers similar to the one he wove

## IDEAS WHAT THE NEXT CENSUS WILL TELL MARKETERS

Reported Missing: the Average American, a.k.a. Jane and Joe Consumer. Odds of locating: slim to none. That's one of the conclusions of a white paper from *Advertising Age* titled "2010 America." Penned by **Peter Francese** of **Ogilvy & Mather,** the paper delves into the demographic changes likely to be revealed by the 2010 census and the attendant challenges for marketers.



While data from the census won't start trickling out until March 2011, some trends can already be glimpsed. First and foremost, gone are the days when advertisers could aim at a single broad demographic. In the 10 largest cities, no racial or ethnic group constitutes a majority. By 2010, white non-Hispanics will make up 80% of the population aged 65 and up but just 54% of Americans under 18. Also, the county's center of gravity is shifting fast. Over the past decade, 85% of population growth occurred in the South and West, while the Northeast and Midwest shrank.

The census will also give marketers a clearer picture of American families than they've ever had, as respondents will have 14 choices to describe their households. Francese projects that by 2010 the most prevalent household will be a married couple with no kids, followed closely by single-person homes—while marrieds with kids will tally a mere 22% of all households.

***Advertising Age***

CHIP SOMODEVILLA/GETTY IMAGES; ILLUSTRATION BY ARTHUR GIRON

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The *Chronicle* has lost more than a quarter of its circulation so far this year

at AIG. Greenberg has hired 13 former AIG executives, raising concerns that he will snatch business away from AIG and harm its prospects of returning $121 billion in bailout money. In a statement issued after the *Times* story appeared, C.V. Starr argued that other firms have hired many more people away from the crippled behemoth, and that the exodus is due to Washington's mismanagement.

### MARCHIONNE REVS UP

Fasten your seat belts—here comes **Chrysler** Italiano. **Fiat CEO Sergio Marchionne** will deliver his fix-it plan for Chrysler on Nov. 4. Controlling owner Fiat aims to use its engineering works to make compact and midsize cars for Chrysler and will offer the **Fiat 500** subcompact in the U.S. Various Dodge models, including the **Grand Caravan**, and several **Jeeps** will disappear. And Fiat's **Alfa Romeo** brand will build an SUV based on the **Jeep Grand Cherokee.** Also on the auto front, Bloomberg reported on Oct. 28 that lender **GMAC Financial Services** is looking for a third bailout from the **Treasury**—between $2.8 billion and $5.6 billion on top of the $13.5 billion it has already soaked up. And **Ford** said on Oct. 28 that China's **Geely Automotive** is the lead candidate to buy Volvo.

| BW | PAGE 022 **"Fiat's Cars May Not Save Chrysler"**

### BLACK, WHITE, AND UNREAD

It's hardly a revelation that more people are giving up newspapers and opting to read news free online. On Oct. 26 the **Audit Bureau of Circulations** said that daily readership fell a steeper-than-expected 11% for the six months ending in September, with the *San Francisco Chronicle* leading losers with a 25.8% plunge. But the overall drop was partly self-inflicted by publishers, many of whom are raising prices and cutting circulation on purpose to control costs, aiming to bring in more dollars by selling fewer papers. What's more, it may be working. Circulation revenues at newspaper group **Media General** rose 11% in the third quarter. **New York Times Co.** saw a 7% climb. Whether those gains can offset vanishing ads is the conundrum keeping weary publishers up nights.

**20.8%**

Proportion of U.S. consumers expecting better business conditions in the next six months, down from 21.3% in September

Data: The Conference Board

## TECHNOLOGY

### A BUMP FOR BAIDU

Baidu, the emperor of online search in China, reported another scintillating quarter on Oct. 26: a 42% profit surge, to $72 million, on a 39% sales increase, to $187 million. With performance like that, no wonder **Google** has made little headway in China, where Baidu has about two-thirds of the market. However, Baidu stock promptly sank 13%. Why? Because the **Nasdaq**-listed company also mentioned that it's bracing for a revenue hit in the fourth quarter, when it will shift to a new management system for its advertising. The stock bounced back in the following days and is still up 90% over the past 12 months.

## LEADERSHIP

### SOROS' NEW THINK TANK

"The entire edifice of global financial markets has been erected on the false premise that markets can be left to their own devices." Them's fightin' words, and that's exactly what liberal billionaire investor **George Soros** has in mind. On Oct. 27, Soros pledged $50 million over 10 years to create an **Institute for New Economic Thinking** that will seek "alternatives to the prevailing dogma" of classical economics. Soros' mission statement continued: "We must find a new paradigm and rebuild from the ground up." Founding advisers include Nobelist **Joseph Stiglitz** and former **International Monetary Fund chief economist Kenneth Rogoff.**



Soros will pour $50 million into a think tank meant to challenge economic dogma

(TOP) JUSTIN SULLIVAN/GETTY IMAGES; (BOTTOM) MIKE THEILER/REUTERS

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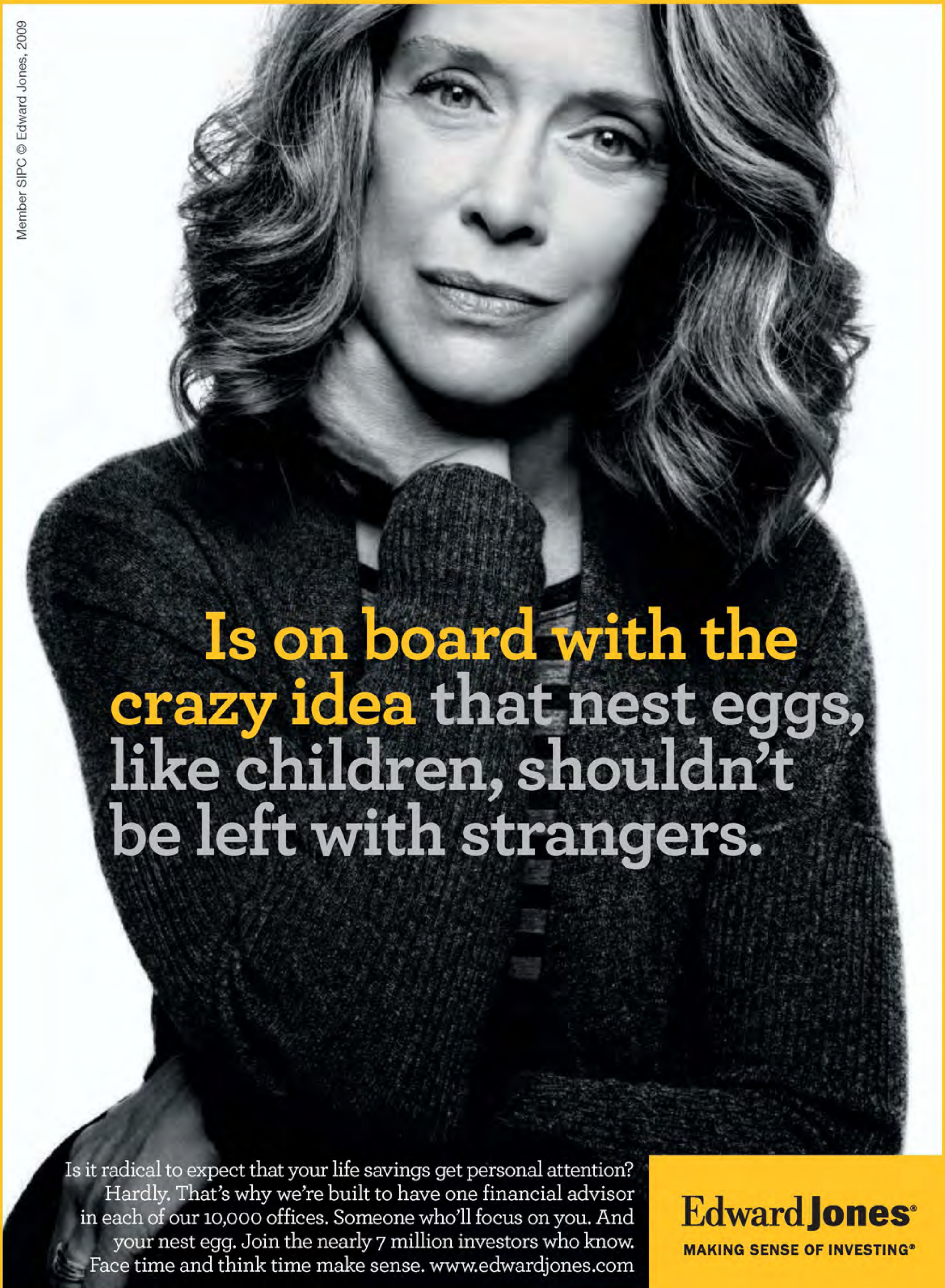
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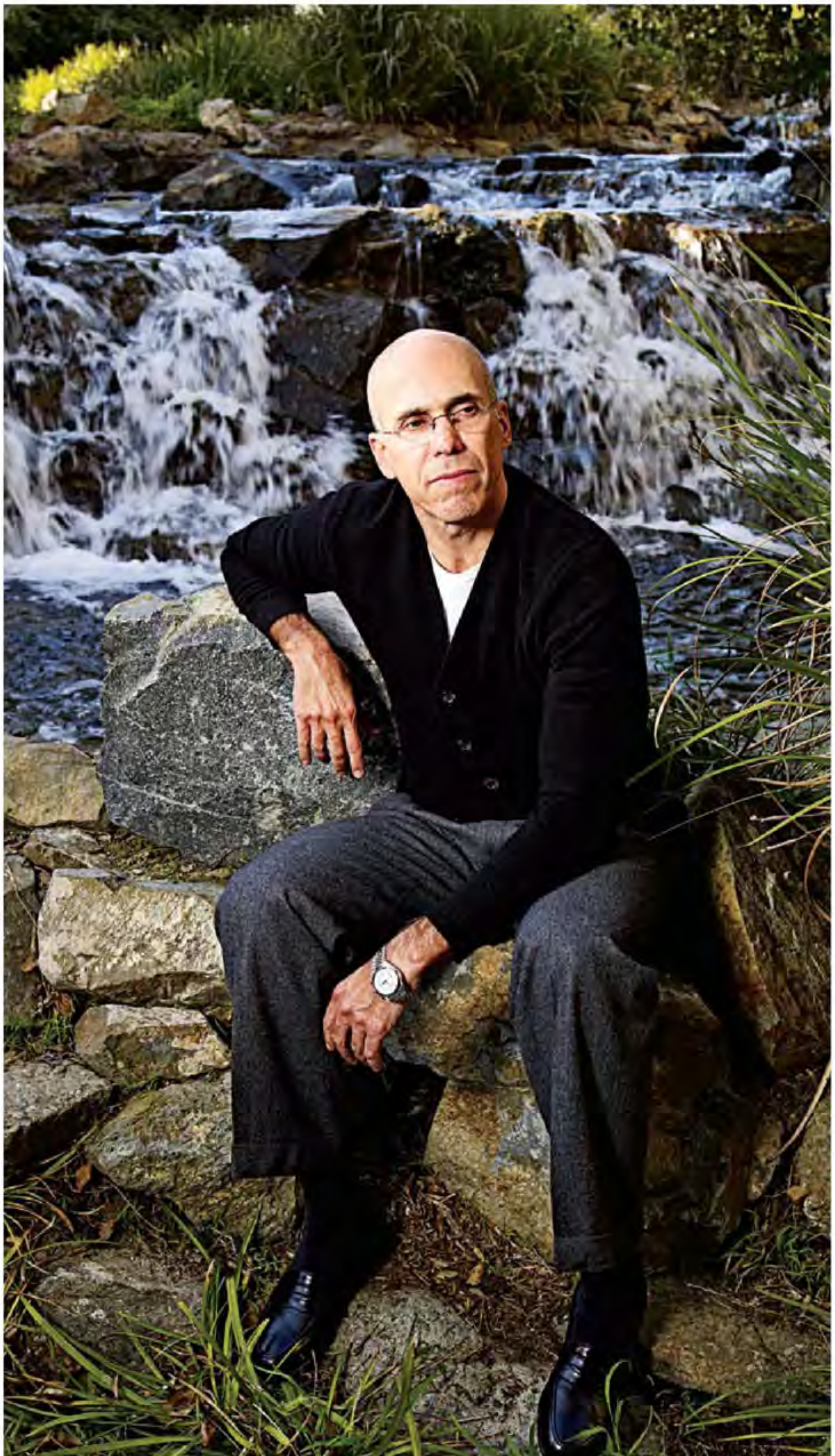
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# FACETIME | MARIA BARTIROMO





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## KATZENBERG: A FRONT-ROW SEAT AT THE MOVIES

Few people know Hollywood better than Jeffrey Katzenberg, the onetime wunderkind who by the time he was in his thirties had already been an executive at Paramount Pictures and was running the motion picture studio at Walt Disney. After a much publicized falling out with then-Disney CEO Michael Eisner and a subsequent court settlement that made him a very wealthy man, Katzenberg started DreamWorks SKG with Steven Spielberg and David Geffen. DreamWorks Animation was spun off from its parent in a 2004 IPO, and Katzenberg became CEO. On Oct. 27, after DreamWorks Animation reported earnings—beating Street estimates for the fourteenth out of the past 15 quarters—I talked with the man who, from *The Little Mermaid* to *Shrek*, has been behind some of the most acclaimed children's movies in history.

MARIA BARTIROMO

**You've been a student of the entertainment business for years. Where is Hollywood headed?**

JEFFREY KATZENBERG

I think a real seismic shift is occurring. Anytime you're in the center of these shifts, it's maybe not the wisest thing to try and be predictive of where it all is going. But in the past—and I'm referring to the last 30 or 40 years—every time a new platform has come along, the motion picture industry as a whole has usually done a fantastic job of transitioning to it and ultimately gaining revenue. And many different

platforms have come along, whether it was free TV or pay TV or VHS or DVDs. Clearly, the next major transformation is going to be from hard goods to digital. There's a lot of uncertainty and caution as to how best to get there. Moving from analog to digital has been disastrous for the music industry. Hopefully our industry has learned from the music business.

**Are movies an endangered species?**
No. I think just the opposite. There's nothing like being in a movie theater with a couple of hundred other people, laughing or being scared or being moved to tears. Those are among the most wonderful social experiences we're all able to have with one another. All these other things are fine and good, but I don't think they are a replacement for movies. I was just in India a week ago, and people are watching movies on their cell phones. They have 450 million people who have cell phones, and [the business is] growing at the rate of 8 million a month. People want to see great stories, and while you have to adapt to these changes, I think they are opportunities, not liabilities.

**Isn't the DVD business weakening?**
Yes, the market as a whole has been pretty challenged in the past 12 months. People are moving from purchase to rental, and there's been a tremendous spurt in the growth of both Netflix and Redbox. But our CG [computer-generated] animated movies are really different from the rest. We are primarily a mom purchase, more analogous to a toy than to a movie.

> **People want to see great stories, and while you have to adapt to changes, I think they are opportunities, not liabilities**

***Shrek The Musical* is scheduled to close in January after just over a year-long run. There are reports that it will not break even. More important, *The New York Times* suggested that this first effort by DreamWorks Animation to compete with Disney on Broadway is essentially a defeat. Is the closing of *Shrek* a defeat?**
No. I think that is a little harsh. First of all, I have to say we couldn't be more proud of the show itself. We've had a respectable, albeit disappointing, run on Broadway. But we have tremendous opportunities to get value out of the asset in the coming years. We have a touring company that will begin in Chicago next summer. We actually filmed the show about 10 days or so ago. And at some point to be determined, we will release it as a DVD. We think there'll be some nice profits.



*Shrek* didn't do well on stage, but Katzenberg believes Broadway still holds "enormous potential"

DREAMWORKS/COURTESY EVERETT COLLECTION

**Will DreamWorks go back to Broadway?**
With the right creative group and the right property, for sure. [Broadway] has enormous potential.

**Speaking of Disney, Bob Iger in a recent interview bemoaned the excesses of Hollywood spending, much as your famous 1991 memo to the industry did when you were at Disney. Is Hollywood addicted to over-the-top production and marketing costs?**
I would have to say I think we [at DreamWorks] are very strategic and thoughtful about where and how we spend our resources to market our films. Maybe we are so focused because we have only three movies a year. Bob is overseeing a $50 billion enterprise that's got so many moving parts, he sort of looks at it from 10,000 feet. I look at it from 10 inches.

**I read a report that DreamWorks has banned the stars of the upcoming *Shrek* sequel from twittering about the movie. Is that true?**
Not true. Somebody twittered that, and it wasn't true.

**So you're allowing the stars to twitter?**
They haven't asked. Let me just say, we have a great cast. They've been partners with us for a decade in this franchise and are free to support the movie in any way they think is good. I have that much trust in them.

**You were one of President Obama's most ardent campaign supporters in Hollywood. How would you rate his performance, and has he disappointed you in any way?**
No, he has not. I think he inherited probably one of the most difficult and challenging agendas of any President in history—certainly in modern history. I think he continues to do a good job of facing unprecedented challenges. I don't know how he does it.

---

*Maria Bartiromo is the anchor of CNBC's* Closing Bell *and writes the blog Maria Bartiromo's Investor Agenda, at investoragenda.cnbc.com.*

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# A HOUSING RECOVERY WITH A SOLID FOUNDATION

**Even if policy supports are ended, home affordability and shrinking inventory point to a sector on the mend. But don't expect recent price increases to continue apace**

The broad improvement in the housing indicators in recent months leaves no doubt that the long-awaited housing recovery is finally under way. In fact, homebuilding added solidly to third-quarter economic growth, its first positive contribution in 3½ years. The question now is: Will it last?

Unlike past housing rebounds, this one has received an extraordinary amount of policy support. Tax credits, programs to aid refinancing and loan modifications, and direct Federal Reserve involvement in the secondary mortgage market have all played roles in reversing the mother of all housing slumps. As this assistance ebbs, the recovery will surely feel the loss, but the upturn is built on a solid foundation of improving economic fundamentals that will keep the rebound going.

**29%**

**Share of distressed* home sales in September, vs. 51% in March**

*Foreclosed or sold below mortgage value

Data: National Association of Realtors

Policy alone cannot explain the 24% gain in existing home sales since January, nor the 22% increase in new-home purchases, the 40% rise in single-family housing starts, and the recent upturn in home prices. The primary driver is historically high affordability. Fixed 30-year mortgage rates are at 5%, a multi-decade low, and prices have plunged a total of 30% since May 2006, based on the Standard & Poor's Case-Shiller Home Price Index. By that price gauge, homes are well undervalued relative to both rents and aftertax income.

Affordability is typically the No. 1 issue for first-time buyers, who also have been helped by Washington's $8,000 tax credit. The National Association of Realtors estimates the program will account for some 350,000 of this year's projected increase in sales of existing homes, but that's only about a third of the 1.1 million rise in existing-home sales since January. The NAR says first-timers accounted for more than 45% of all sales in the past year, somewhat above the 40% average for 2007 and 2008.

The share of first-time buyers has most likely risen in recent months, with people scrambling to get a closing date before the Nov. 30 expiration of the tax credit. It now appears Congress will extend the program, which will add a dollop of sales support in 2010. Still, some recent purchases may well have been pulled forward by the program, which could result in temporarily weaker sales in coming months.

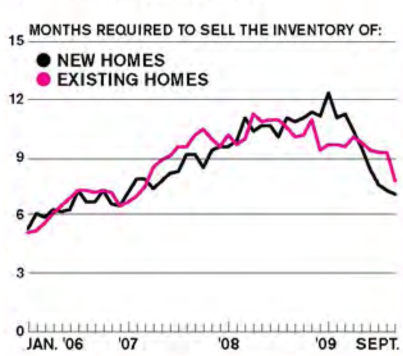
The most important impact of stronger demand has been the rapid shrinkage in the inventory of unsold homes, a key reason prices are firming up. Builders' supply of new homes has shrunk dramatically. It would take 7.5 months to sell their inventory at the September sales rate, down from a peak of 12.4 months in January. Current trends in sales and inventories suggest supply will dip below the pre-2006 long-term average of about six months by yearend. Builders have cut output so far below sales that inventories can decline, even as starts increase.

The supply of existing homes in September fell to 7.8 months, down from a peak of 11.3 months in April 2008 and the lowest in 2½ years. Given this year's trends, inventories will drop below seven months by yearend. A level consistently below seven months would indicate a better balance between supply and demand, further bolstering the pricing outlook.

However, don't expect housing activity—and prices in particular—to rise at the rate of recent months. The S&P Case-Shiller index of prices in 20 cities rose 1% in August, the third consecutive advance, bringing the annual rate of increase since May to 12.7%. That pace will be difficult to sustain as policy support begins to fade. Plus, economists are wary of a so-called shadow inventory that could lift supply later, reflecting future foreclosures, foreclosed homes that banks may be holding off the market, and a possible crush of would-be sellers next spring.

All these factors are likely to limit the potential strength of the housing recovery. However, the thrust from exceptionally favorable buying conditions will not disappear anytime soon, and the broader economic recovery and improving credit markets will only add further fuel. | BW |

## THE SHRINKING SUPPLY OF UNSOLD HOMES




Data: U.S. Census Bureau, National Association of Realtors, IHS Global Insight

BRAD TRENT; CHART BY DAVID FOSTER

# NUMBERS

## AMERICA'S MEDICAL BILL JUST KEEPS ON CLIMBING

By Tara Kalwarski/Charts by David Foster

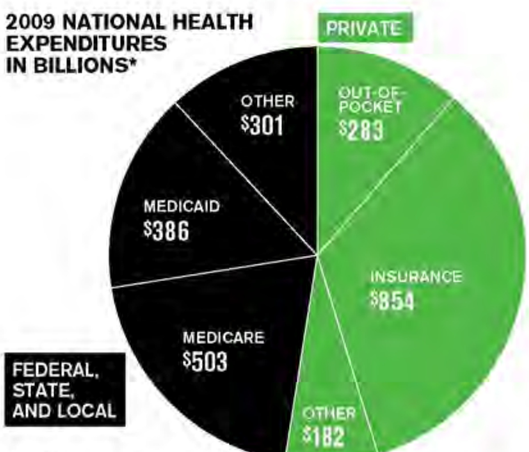
The U.S. spent an estimated $2.4 trillion on health care in 2008, about 16.5% of gross domestic product and a 6% increase from a year earlier. Medical care prices are rising faster than overall inflation, and the burden on consumers continues to grow.

**5.5%**

**Rise in average annual family premium for employee health insurance in 2009, to $13,375. Single-person coverage was up 2.6%, to $4,824.**

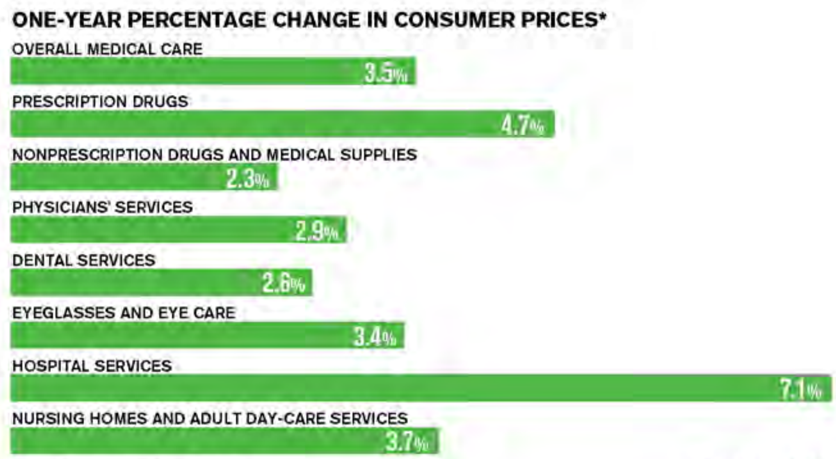
Data: Kaiser Family Foundation, HRET

**Spending sources:** Private insurance accounts for the single biggest share.




*Projected
Data: Centers for Medicare & Medicaid Services, Office of the Actuary

**Racing ahead:** Health-care prices have swelled by 3.5% in the past year, compared with a 1.3% decline in overall inflation.




Data: Bureau of Labor Statistics

*As of Sept. 2009

## A GROWING CONCERN

U.S. health-care spending as a share of GDP has risen by 10.6 percentage points since 1965.




Data: Centers for Medicare & Medicaid Services, Office of the Actuary; Bureau of Economic Analysis

*Estimated




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ILLUSTRATION BY MICHAEL BYERS

# OH, YOU SHOULDN'T HAVE. AND HERE'S WHY

Wharton School economist Joel Waldfogel has built something of a reputation as a Christmas killjoy. Starting with a 1993 article in the *American Economic Review* ("The Deadweight Loss of Christmas"), he has been rattling the chains of Yuletide gloom.

Waldfogel says holiday spending is "a massive institution for value destruction." That's economist-speak for the fact that so many gifts—billions of dollars' worth, he contends—match up so poorly with what recipients want or would have bought for themselves. Now, in a new book, *Scroogenomics* (Princeton University), he puts an updated figure on the waste arising from holiday giving. "U.S. givers spent $66 billion in 2007," he writes, but the value of recipients' satisfaction is much lower. Quantified, the satisfaction gap represents "an annual deadweight loss of $12 billion." That's approaching what the federal government dissipates yearly, he says, citing the $17.2 billion in misspending estimated by Citizens Against Government Waste.

Waldfogel's estimates of the lost value in holiday giving derive from student surveys he has conducted over the years. At first he simply asked recipients to estimate the total cost of the gifts they got and the amount they would have been willing to pay for them (apart from any sentimental value). In later surveys he asked participants to estimate prices and values both for the gifts they got and for stuff they had purchased for themselves. People ascribed 18% more value per dollar spent to their own choices.

The least "efficient" gifts, Waldfogel writes, tend to be from relatives who don't see family members often enough to know their desires. ("Nobody is better than you at buying the sweater you want," he said in a phone interview.) And while giving cash is a way to preserve gift value, it's often considered inappropriate or cold.

Gift cards, which now represent up to a third of holiday spending, are stigma-free, Waldfogel notes. But 10% of their value goes unredeemed each year. His suggestion: Retailers should donate those balances to charity. *–Hardy Green*



## BTW

## TIME TO BUY HQ?

Many investors have given up on real estate. But one group has been on the prowl for property: corporations. Fully 10% of commercial real estate transactions in 2009's first half were corporations acquiring office buildings, sometimes the very ones in which they were renters, according to market tracker Real Capital Analytics. That's up from an average of 2.3% earlier in the decade, when many businesses sold their buildings—leasing the space they needed—as property values zoomed. Among those switching from tenants to owners this year: Sotheby's, which bought back its Manhattan headquarters for $390 million; and video game developer Electronic Arts, which paid $233 million for the Redwood City (Calif.) headquarters that it had always leased. Jay Koster, president of Jones Lang LaSalle's Capital Markets, says that with many companies sitting on cash and office-property prices at 25% to 50% below 2007 peaks, such moves make sense. If values bounce back, these buyers can sell and become tenants again, banking the gains. *–Michael Arndt*




Sotheby's went from tenant to owner of its NYC headquarters for $390 million

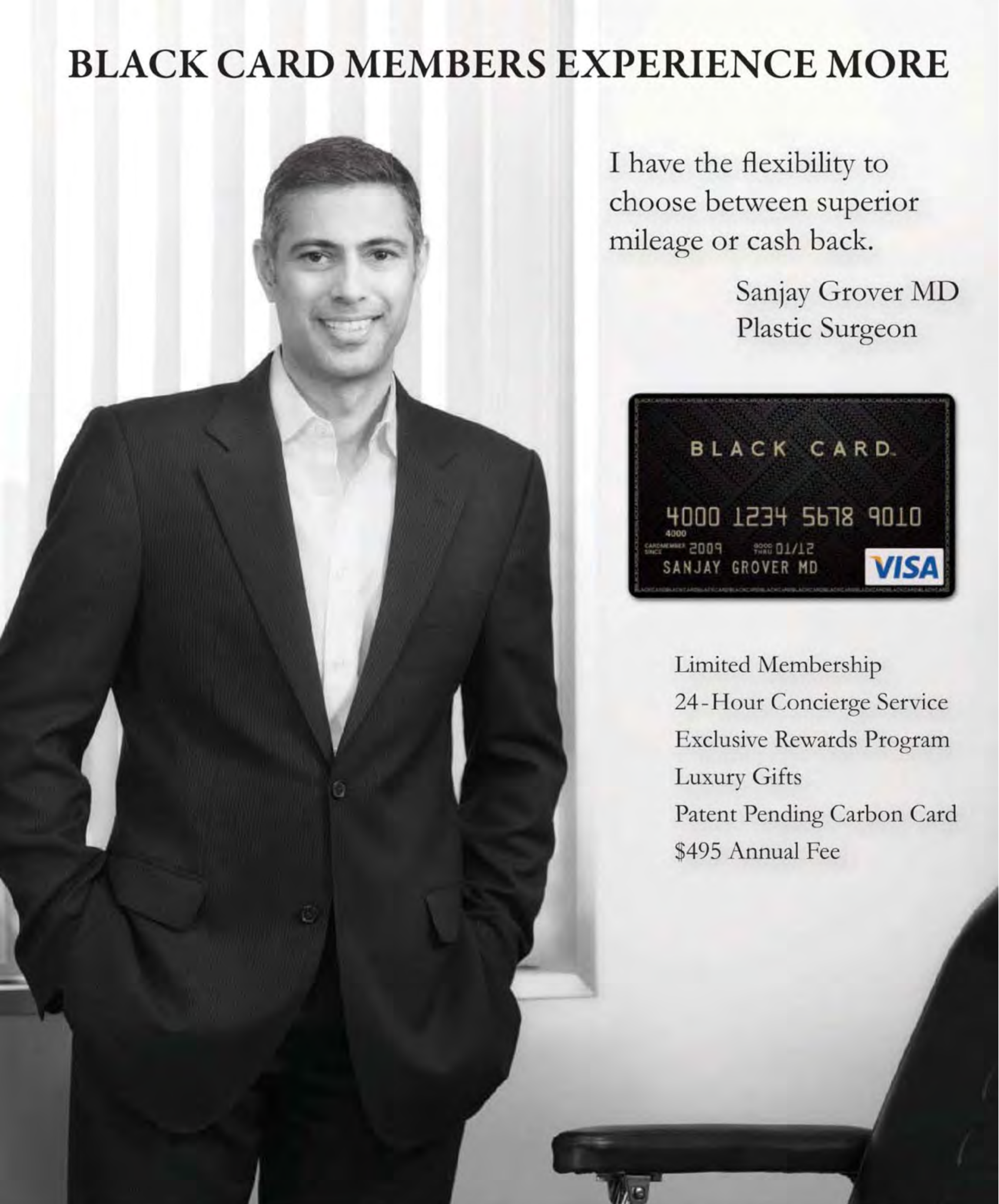
ILLUSTRATION BY MICHAEL BYERS; PHOTOGRAPH BY SONDA DAWES/THE IMAGE WORKS

## MOSCOW'S NEW COLD WAR: BLITZING THE BLIZZARDS

Now here's an option that's not available to most budget-strapped snowbelt cities: Moscow Mayor Yuri Luzhkov plans to preserve funds, as winter descends, by having less snow fall from the sky.

With the blessing of his city council, Luzhkov has announced that in the coming months, Russia's air force will bombard snow clouds with silver iodide as they head toward Moscow. The idea is to make them release their precipitation before they reach the capital. (Cloud seeding is not unknown in Russia, where it has been used from time to time to ensure that nothing rains on parades.)

City public works officials told ITAR-Tass that the seeding, to be carried out from November to March, will cost $6 million—a sizable reduction from the $10 million a year Moscow spends on the 5,000 heavy trucks and 50,000 workers needed for snow removal. (No word on whether the city will find jobs for the unneeded workers, as Russia copes with an unemployment rate that is officially around 8% and unofficially estimated at twice that.) The air force maneuvers won't keep the capital completely flurry-free, says city government spokesman Igor Pergamenshik. "It doesn't mean Moscow will see in the New Year under green trees. There will be snow." *–Miriam Elder in Moscow*




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# FIAT'S CARS MAY NOT SAVE CHRYSLER

## The new models won't materialize for two years—and the U.S. automaker could stall out in the meantime



By David Welch

Fiat CEO Sergio Marchionne has said little about his plans to reinvigorate Chrysler since agreeing to acquire the U.S. automaker in June. But what he has said is telling. In a chat with reporters on the sidelines of the Frankfurt Motor Show in September, he acknowledged being chagrined by Chrysler's woeful condition and the discovery that its previous owner, the private equity shop Cerberus Capital Management, had done so little to prepare the automaker for the future. Marchionne said he'd found "a whole pile of surprises."

And the surprises keep coming. No one, certainly not Marchionne, expected Chrysler to be a shiny new car company when it reemerged from bankruptcy in June. But even for an industry as troubled as this one, the numbers have been shockingly bad. Chrysler's sales in the U.S. are down

## WARNING LIGHTS

| 55% | $3,609 | 9.2% |
|---|---|---|
| Proportion of Chrysler sales that went to corporate and rental fleets in September. | Average incentive per vehicle Chrysler offered in October —more than any major rival. | Chrysler's market share through September. It was 11% a year ago. |

Data: CNW Marketing Research, Autodata

40% in the past year, and market share has slipped from 11% to 9%. You know an automaker is in deep trouble when it is selling more than half of its vehicles to corporate and rental fleets, as Chrysler did in September, according to CNW Marketing Research.

Chrysler badly needs appealing new models if it is to have a hope of surviving. On Nov. 4, Marchionne will lay out his plan, which, according to industry insiders, involves plugging Chrysler's product holes with Fiat-engineered cars. (Chrysler declined to comment on the plan.)

That will be a vital first step. The trouble is that the new vehicles won't appear for at least 18 months. Between now and then, Chrysler's market share will almost certainly continue to erode, making it all the harder for the company to stay in the black and develop and market new models. The question for Marchionne, says IHS Global Insight analyst John Wolkonowicz, is: "How do you get Chrysler from here to 2012?"

When the Italian CEO lays out his strategy, no constituency will be listening more intently than Chrysler's suppliers. As sales keep dropping, some parts makers are getting leery about accepting Chrysler business. They fear winding up with a bunch of production capacity and eating production costs if Chrysler can't sell enough cars or doesn't survive. Thomas T. Stallkamp is a partner at Ripplewood Holdings, the private equity firm that owns German engine parts maker Hansel International. In anticipation of lower sales, he has already renegotiated a contract to sell engine blocks to Chrysler. "Our guys in Germany are worried that the sales volumes won't make it," Stallkamp says. "Every month that sales go down, suppliers get more nervous."



ILLUSTRATION BY PHILIP BURKE

**Some parts makers are leery of Chrysler orders for fear of winding up with unsold inventory and excess production**

Some suppliers have simply decided not to sell parts to the company. Charles A. Gassenheimer, chairman and CEO of lithium ion battery maker Ener1, passed on a chance to sell batteries for Chrysler's planned electric cars. He thought it was too risky. "Does Chrysler have the cash to commit to that program? No," Gassenheimer says. "We don't have the resources to bet on a program like that."

If Chrysler is to have a hope of boosting sales, it will need a strong network of experienced dealers. Over the past year, Chrysler has pared its dealership ranks by a quarter, bringing the number to 2,400 nationwide. At the same time, the company has been pushing dealers to bring all three of its brands—Dodge, Jeep, and Chrysler—under one roof. Building new retail space is expensive, and many dealers need to borrow the money.

### DEATH OF A CAR SALESMAN

Now a number of them can't get loans and may bow out. Leo Griggs has been selling Dodges in the tony Park Cities neighborhood of central Dallas on and off for the past 15 years. In January, Griggs acquired a Chrysler-Jeep franchise to go along with his existing Dodge showroom and borrowed $22 million from Chrysler Financial. But when Chrysler went into bankruptcy, the Treasury Dept. decided to wind down Crisper Financial and designate GAMIC Financial Services, the former General Motors unit, as lender of choice for Chrysler dealers and customers.

GMAC, which in late October asked the government to shore up its finances, gave Griggs a temporary credit line to buy cars from Chrysler. But GMAC would renew the credit line only after Chrysler Financial released the liens on his dealership's assets. And Chrysler Financial refused unless Griggs paid all the money back at once. Griggs was forced to shut his business. And Chrysler lost an experienced dealer. "I never understood that any-

thing like this could happen," Griggs says. Chrysler says its dealer network is stronger, but with sales down, many are struggling.

A credible turnaround plan from Marchionne could go a long way toward calming the nerves of suppliers and dealers, Stallkamp says. And Marchionne plans an extravagant rollout—an eight-hour sales pitch in Detroit to the media and financial community.

People familiar with his plans say he wants to develop Chrysler and Fiat cars together, sharing parts, vehicle platforms, and engineering in a way former parent Daimler never did. He also wants to export Jeeps, a plan that would be helped by a cheaper dollar. Says James N. Hall, who runs the auto consulting firm 2953 Analytics in Detroit: "Jeep has a lot of upside potential."

### AN EMERGING BRAND STRATEGY

For the U.S., Marchionne may replace the weak Chrysler Sebring and Dodge Avenger with midsize cars using hardware engineered for Fiat cars in Europe. Alfa Romeo may also build a premium SUV using the underpinnings of the Jeep Grand Cherokee. And Fiat's premium Lancia brand may replace its flagship car, the defunct Thesis, with a sedan built alongside Chrysler's 300. That car would sell only outside the U.S., but its sales volume could help make Chrysler's factories more profitable.

As Marchionne's product plan rolls out, the brand strategy will take shape. The Ram truck brand will be split from Dodge, which will sell entry-level cars and sporty rides. Chrysler will maintain its higher-priced status. Jeep will be strictly SUVs. And Alfa Romeo will be offered as a lower-priced (but still upscale) sporty rival to BMW.

Marchionne's grand plan is to create a global car giant by combining the best pieces of Fiat and Chrysler. The strategy makes sense on paper. But the best-laid global plans can be undermined by heavy losses in the U.S. market. That's what happened to GM. Shoring up Chrysler at home won't be easy, not in this competitive environment. "Chrysler can make it," says Hall. "The question is, how committed is Fiat to saving Chrysler?" |BW|

# CREDIT CREAKS INTO GEAR

**Wall Street is starting to package and sell debt again, which should help the economy**



**By David Henry**

Wall Street's great credit machine, which once provided more than \$2.5 trillion to consumers and fueled a long economic expansion, stalled when Lehman Brothers failed in September 2008. But this giant financial engine, known as the shadow banking system, may be sputtering back into gear. With traditional bank lending contracting, any new money from private investors should help get the economy moving.

The difference now is that the government is supplying much of the grease to get these markets running. That's not likely to change anytime soon: For the foreseeable future, the feds will be a fundamental part of the new credit reality.

### FASTER REFINANCING

In normal times, Wall Street bundles mortgages, credit cards, auto loans, and other debt into bonds and sells them to investors. The process, known as securitization, then frees up banks to make new loans. It's the lifeblood of the economy.

Slowly, Wall Street is reprising its critical role in the credit markets. In the third quarter investment banks sold nearly \$20 billion worth of car loans, six times as much as in the same period of 2008. The yields on bonds backed by credit-card payments have fallen drastically, a sign that investor appetite is back. And the volume of mortgage securities, the largest segment of the credit market, is on track this year to nearly match the peak levels of 2005. "The core consumer finance sectors seem to be reasonably intact," says Joseph R. Mason, a finance professor at Louisiana State University.

The improvement in the securities market is helping the likes of Brian Mayes, who runs a publicity firm outside Nashville. The 36-year-old tried for four months to refinance the \$430,000 mortgage on his four-bedroom brick house. One lender he'd lined up went bankrupt before the paperwork on the loan was processed. In August his new application with F&M Bank, a small Tennessee lender, went through in just 10 days. "I'm relieved and surprised," says Mayes, who cut the rate on his loan to 5.25% from 6.5%. "I thought that I was never going to get this thing refinanced."

To be sure, the credit machine isn't operating anywhere

## FUELING THE MACHINE

The securitization market is coming back to life, albeit with help from the feds

| SECURITIES | 2009 AMOUNT* (\$BILLIONS) | YEAR-OVER-YEAR CHANGE |
|---|---|---|
| Mortgages | 1,526 | ▲36% |
| Auto Loans | 39 | ▲17% |
| Credit Cards | 40 | ▼33% |
| Home Equity | 4 | 0% |

* Through September

Data: Securities Industry & Financial Markets Assn.



near full capacity. Securities stuffed with student loans amounted to just $15.5 billion in the first three quarters of the year, down 45% from the same period in 2008. And investors won't touch a mortgage deal unless it has the backing of the feds. That makes it nearly impossible for borrowers to get exotic subprime mortgages and other risky loans. To land so-called prime jumbo loans above $729,000, borrowers have to pay a premium. Those sorts of mortgages once accounted for nearly $900 billion of investments.

**LENGTHY SHAKEOUT**

But some of that credit should never come back. During the boom times, consumers borrowed way beyond their means, often betting home prices would go up forever. At the height of the market, for example, home equity loans accounted for more than 60% of asset-backed securities, not including traditional mortgages. A decade ago, that piece represented about one-third of the market. With home values at record lows, there are barely any home equity deals today.

What's happening now is a rationalization of credit. In essence, the market is trying to find the right balance between too much and too little. "It is a really tough question to untangle, and it is one that is crucial to economic growth," says LSU's Mason.

The process, which is happening along the entire food chain of credit, from borrowers to lenders to the government, will take years and ultimately reshape the debt markets. Lenders, for example, are trying to figure out how to dole out money prudently. Rivermark Community Credit Union, a small lender in Beaverton, Ore., made 442 auto loans in September, 33% more than the previous year. "I think peoples' confidence is returning, and they are feeling a bit more secure," says Gayle Rust Gustafson, vice-president for financial services at Rivermark. Even so, Rivermark is tightening lending standards: It's cutting the amount of items, such as the unpaid balance on a trade-in vehicle, that a borrower can roll into a new car loan.

Meanwhile, parts of the credit market are beginning to inch toward self-sufficiency and away from government subsidies. Consider the auto and credit-card segments. The first big spark of interest in such securities came from a $200 billion federal initiative started in March. Under the Term Asset-Backed Securities Loan Facility, or TALF, the U.S. agreed to help finance purchases by private players. The incentives have persuaded so many investors to scoop up auto and credit-card securities that deals are now being sold without federal aid. "The program has been very successful," says Theresa O'Neill, a credit market strategist at Bank of America Merrill Lynch Global Research. The volume of auto securities is on pace to hit $50 billion this year, up from $35 billion in 2008, according to the Securities Industry & Financial Markets Assn., an industry trade group.

Housing, which is being entirely propped up by federal funds and programs, will be trickier. This year government-backed loans have accounted for 99%, or $1.5 trillion, of mortgage securities. Banks and other private firms have issued a mere $15 billion. The breakdown has been more like 80/20 in the past. In addition, the Federal Reserve and Treasury have spent nearly $1.25 trillion buying those bonds to support the housing and broader credit markets. "The government is literally plowing trillions of dollars into the U.S. mortgage market to keep it afloat," says Guy D. Cecala, publisher of *Inside Mortgage Finance*.

The Fed has said it intends to quit buying mortgage securities by the end of March. Whether it does stop at that point may well depend on whether private players plunk down more money. That could take awhile. At the moment, says Sam Khater, a senior economist at First American CoreLogic, investors "are waiting for stability in home prices and the economy"—just like everyone else. |BW|

*–With Prashant Gopal in New York and Theo Francis in Washington*

ILLUSTRATION BY JOHN HERSEY

# ARE JUNK BONDS TOO HOT TO HANDLE?

**An investor stampede has produced returns twice as high as stocks this year. Now the red flags are out**

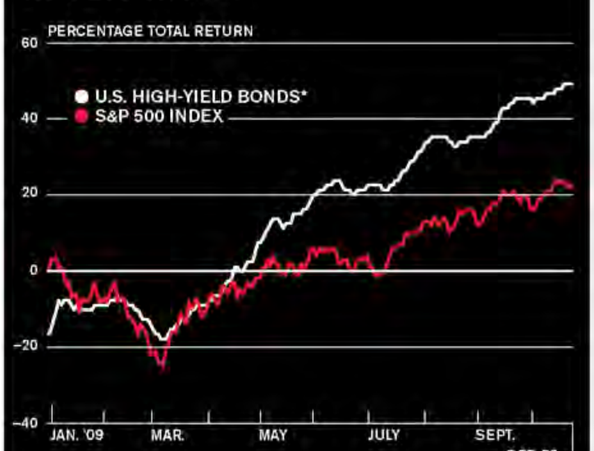
By Roben Farzad

At the credit bubble's frothiest, legions declared that risk was overrated. Securitization, syndication, and all kinds of slicing and dicing, the thinking went, could confer creditworthiness on pretty much any object, animate or otherwise. Then came the debt market implosion. As default rates spiked for speculative junk bonds, all but the most rarefied of corporate issuers were out of luck.

But barely a year after the world nearly ended, junk debt is staging a record resurgence. In 2009 these riskier corporate bonds (rated below investment grade) have so far returned 52%, well north of the previous record of 39% set in 1991. Untrue to form, these high-yield securities have even vastly outperformed equities, more than doubling the Standard & Poor's 500-stock index's year-to-date return of 19%. Issuance is surging, and hot money is sluicing in. In other words, caveat creditor.

True, a junk-bond rally makes sense given all the panic selling last year on fears of economic Armageddon. In 2008 high-yield bonds dropped 26%, their worst one-year showing ever. The price of the securities plummeted as yields skyrocketed as high as 22% by November 2008. Issuer defaults, which obliterate junk returns, multiplied as the credit freeze took hold. Accordingly, the high-yield market's spread, or the excess return over Treasuries demanded by investors, surged to a record of more than 19 percentage points. The entire junk-bond market basically closed for business.

## MEGA-RALLY




Data: Bloomberg *Barclays Capital U.S. Corporate High Yield Index

But with defaults expected to peak soon, investors have spent the better part of 2009 bidding up junk bonds, abruptly pushing their spread to Treasuries down to 7.5% (page 62). "The fact that the world is breathing shows you how mispriced junk was," says Jim Delaney, a veteran bond trader turned credit market strategist.

> **Investors may be ignoring historically high levels of default risk, increasing the chances that the market will overheat**

The mood shift in the junk-bond market owes much to the trillions of dollars' worth of bailouts, backstops, and monetary and fiscal packages, a reality that seems to have been lost on investors' hunt for higher yields amid extraordinarily low short-term interest rates. "The Fed," laments hedge fund guru Jeremy Grantham, "is beating investors into buying junk and other risky assets, a hair-of-the-dog strategy if ever there was one." So ferocious has the stampede into junk been that the bonds now yield less than their two-decade median, according to Leuthold Group, a Minneapolis investment management firm.

### CAUTION: DEFAULTS

Another red flag, at least among fixed-income cognoscenti, is that for the first time in five years the default rate for junk bonds now exceeds their spread to Treasuries. All of which suggests investors are ignoring historically high levels of default risk, increasing the chances that the market rally will overheat or even collapse. "We expected high-yield bond yields to come down, but not this fast," Leuthold analysts wrote in an October dispatch, in which the firm urged clients to start taking profits. "We expected a three- to four-year play, not nine months."

But good luck trying to tell a white-hot junk-bond market to chill. According to Dealogic, the current quarter's new junk issuance is tracking at just a bit less than $42 billion—nearly eight times the sales of a year ago. Lipper FMI reports U.S. junk-bond mutual funds are working on their ninth straight week of net inflows: $329 million last week, on top of $237 million the week before. Investors have directed $28 billion to junk funds so far in 2009, more than in any entire year since 1992.

Too far too fast? "It's fairly dangerous right now to be going back in the soup so quickly after where we were," warned Richard Handler, the chief executive of Jefferies Group, in an Oct. 20 conference call. The investment bank had just quadrupled its bond-trading revenue, thanks in no small part to the junk rally. Not coincidentally, Jefferies also used the occasion to announce a $300 million debt offering of its own. |BW|

CHART BY DAVID FOSTER



# VERIZON MOBILIZES AGAINST THE iPHONE

**To stay ahead of AT&T and Apple, the carrier is placing a big bet on Android smartphones and other new gadgets**

**By Spencer E. Ante**

Can Verizon Wireless keep its spot as the leading wireless company in the U.S. if it doesn't have the industry's hottest phone?

Lowell McAdam, the company's chief executive, is trying to make the case that it can. Two years ago, Verizon Wireless passed on the chance to become the exclusive U.S. distributor of the Apple iPhone and pushed Apple into the arms of rival AT&T. Since then the iPhone has become a megahit, helping AT&T close the gap with Verizon. In the most recent quarter, AT&T added 2 million wireless subscribers, bringing its total to 81.6 million, while Verizon Wireless added 1.2 million, for a total of 89 million.

Now, McAdam is launching a slew of products designed to keep Verizon ahead. In the fourth quarter the company is rolling out its largest new-product lineup ever: 14 devices, vs. half that number a year ago. Among those will be two netbooks and five smartphones, including the Droid phone from Motorola, a sleek device with a touchscreen and keyboard that runs on Google 's Android operating system. The new products are backed by an unusually aggressive marketing campaign. In one TV spot, Verizon takes direct aim at Apple with a series of "iDon't" quips that explain all the things an iPhone can't do. "The Droid can compete head to head" with the iPhone, says John Stratton, chief marketing officer of Verizon Wireless.

Verizon's strategy is bold but risky. With the Droid and another phone from HTC (page 55), Verizon is placing a big bet on the unproven Android. The software is popular with techies and has attracted enough support from developers that 10,000 apps are available for download to Android phones, but it hasn't yet caught on with consumers. In addition, Verizon risks confusing customers with the sheer number of devices it's introducing. "Greater choice is not a guarantee of a greater quarter," says Richard Doherty, research director at Envisioneering Group.

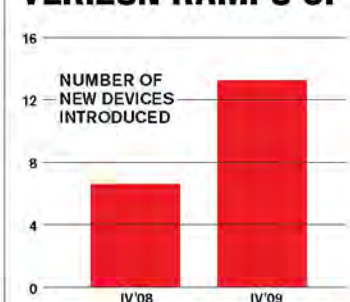
McAdam and Stratton are firing up Verizon's marketing machinery to win over consumers. The Droid will be backed by Verizon's biggest marketing campaign ever for a single device, and total marketing spending will increase 5% to 10% in the current quarter from last year. Stratton says the anti-Apple vibe will be toned down in favor of ads that underscore the features of its phones and the reliability of its network compared with AT&T's. Verizon has said it is still interested in selling the iPhone if Apple is amenable.

Verizon is experimenting with new marketing approaches. For several weeks in November, the company has rented time on two huge electronic billboards in New York's Times Square that will show real-time results of searches people make on their Android phones. Verizon is also planning to transform Droid, the moniker for the Motorola phone, into a brand name for a whole lineup of Android devices.

Verizon's success may ultimately depend on how the partnership with Google works out. As cell phones become more sophisticated computing devices, wireless companies need Silicon Valley firepower to compete. Google has helped boost the number of wireless applications available on Android phones, but analysts say it has to step up its marketing of Android to gain ground on Apple. "When the iPhone was associated with Apple iTunes, that really meant a lot to consumers," says Ken Dulaney, an analyst at researcher Gartner. "You want to know that the [Android] app store is being run by Google." |BW|

*-With Arik Hesseldahl in New York and Robert Hof in Silicon Valley*

**VERIZON RAMPS UP**




Data: Verizon Wireless

ILLUSTRATION BY OTTO STEININGER; CHART BY RAY VELLA/BW



In Monterrey: Cemex's sales are still dropping, but not as fast as earlier this year

# HARD TIMES EASE FOR A CEMENT KING

**Mexico's Cemex survived a near default. But a return to double-digit growth could be years off**

By Geri Smith

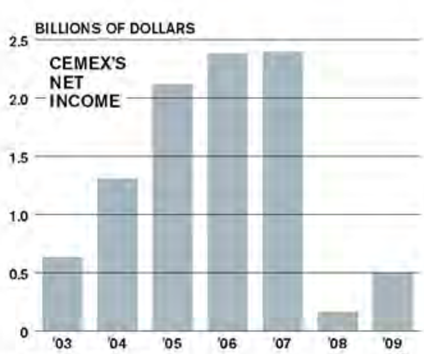
MONTERREY, MEXICO

For the head of a company that has just been through the worst stretch in its century-plus history, Lorenzo H. Zambrano is awfully cheerful. Over the past year the CEO of Mexican cement giant Cemex has seen the company's stock collapse, its investment-grade rating stripped away, its sales wither, and its creditors balk at refinancing $15 billion in debt, raising the specter of default. So why is the 65-year-old in such good spirits? "Because things are so much better than six months ago," he says with a belly laugh. "I really hope to never go through something like this again."

Cemex's latest results hint that the worst may indeed be over. True, third-quarter earnings fell 40% as sales dropped 27%. But that's better than the previous quarter, when profits fell 58% and sales were off 34%. Still, it may be years before Cemex returns to the days when serial acquisitions delivered double-digit growth and bankers vied to finance Zambrano's dealmaking.

In his 24 years at the helm, Zambrano has built Cemex into the world's No. 3 cement producer, with operations in 50 countries and $17.8 billion in revenues last year. Along the way, Zambrano's crew developed a well-honed formula, heavy on high tech and dubbed The Cemex Way, for squeezing out efficiencies. Cemex's knack for integrating acquisitions became the subject of Harvard Business School case studies and earned it a place in the elite club of emerging multinationals.

## CRACKS IN THE CONCRETE




Data: Cemex, UBS

So when Zambrano saw an opportunity to be a major player in the U.S. three years ago, bankers didn't flinch. They jumped at the chance to lend him $15 billion to buy Rinker Group, an Australian company that did 85% of its business stateside. But in mid-2007, as Cemex was finishing the hostile deal, credit markets were tightenimg, making it tough to find buyers for $5 billion in Rinker assets Zambrano had hoped to unload to pay down debt. With the turmoil in global real estate, sales in Cemex's top three markets—Mexico, the U.S., and Spain—were plunging. Then a slide in the Mexican peso last October triggered $700 million in losses on currency hedges.

### NO BONUSES

But the worst was yet to come. Last January, Standard & Poor's dropped Cemex's investment-grade rating. Then in March, Zambrano had to pull the plug on a $500 million bond offering after prospective buyers demanded 20% returns. It didn't help that the prospectus noted that auditors had "substantial doubt" whether Cemex could "continue as a going concern."

Zambrano sat down with creditors to renegotiate the $15 billion in debt from the Rinker acquisition. The talks kept executives holed up at Monterrey headquarters nights and weekends where, despite 100 degree-plus weather, the air conditioning was shut off to save money. Other moves yielded bigger savings. Last year's bonuses were canceled, the workforce was trimmed by 9%, and capital expenditures were cut 75%.

Lenders in August agreed to refinance Cemex's debt, but they demanded that through 2014 the bulk of the company's cash flow go toward repayment. And if the U.S. economy doesn't recover quickly, Cemex "could take another hit," says Gordon Lee, Latin America research chief for brokerage UBS. Zambrano, though, isn't about to apologize for past risk taking. "If every time we were buying something we made plans for a tragedy that only comes every 100 years," he says, "we never would have made a move." |BW|

PHOTOGRAPH BY SUSANA GONZALEZ/BLOOMBERG; CHART BY DAVID FOSTER

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# DON'T TOUCH THAT DIAL

**Networks are creating ads—with their stars and sets—to keep viewers tuned in**




Sprint ads, shot on *Desperate Housewives'* sets, keep more viewers watching

ILLUSTRATION BY TOMER HANUKA

**By Burt Helm and Ronald Grover**

When Microsoft told television executives earlier this year that it was looking for ideas on how to spend hundreds of millions of dollars in advertising, the network guys sprang into action. With the recession in full swing, fewer companies were launching major campaigns. Microsoft was launching two: one for its upcoming Windows 7 operating system and one for its new search engine, Bing.

The networks didn't simply pitch choice ad time or even product placements. They offered to create ads for Microsoft, starring actors from hit shows who appear in character and use the company's products. As part of a larger deal, NBC Universal sold Microsoft on a series of Bing ads, tied to comedian Joel McHale's show *Community*. In one, McHale uses Bing to find countries where he can learn to speak Spanish after lying to a pretty girl that he's fluent. Fox, meanwhile, sold Microsoft a package including a 30-minute show made by *Family Guy* creator Seth MacFarlane featuring Windows 7.

TV networks have sold advertisers custom-made commercials for decades, but they're marketing them much more aggressively. Starting in 2007, companies began paying networks based on how many people watch not the shows but the commercials. Meanwhile, as of May, a third of households owned ad-skipping DVRs, according to Nielsen. So networks are more desperate than ever to get viewers to watch advertisers' commercials.

Custom-made ads sometimes feel like a throwback to the earliest days of television, when a host extolled a product's virtues before the camera. In a taped ad that ran on Comedy Central this summer during the sketch comedy *Michael & Michael Have Issues*, one of the two Michaels holds a cup of Dunkin' Donuts coffee while repeating the chain's slogan, "You kin' do it." The other excoriates him for being insufficiently creative. "You gotta relate to the product," he says.

**Microsoft went as far as signing on for a Windows 7-inflected *Family Guy* special—before balking over the raunchy content**

### HYBRID PRODUCTIONS

Companies like the way these ads blend in with the shows. "It's closer to being TiVo-proof," says Cynthia Ashworth, vice-president for consumer engagement at Dunkin' Brands. And unlike product placements, in which the brand is subservient to the plot, advertisers have more control over their messages.

ABC won a wide-ranging deal with Sprint, developing eight 45-second spots to pair with *Desperate Housewives*. The series of ads, written by *Housewives* creator Marc Cherry and shot on the show's sets, features a woman who uses her phone to find out whether her husband is cheating. "We wanted something that would get us noticed and provide entertainment," says Stephanie Kelly, a Sprint manager who places such commercial hybrids on TV. The bet is paying off: According to TiVo's StopWatch system, which anonymously tracks viewing habits, more than twice as many people watched the vignettes as watched other commercials during the program.

These hybrid deals can be risky. When Fox offered to have MacFarlane cook up the 30-minute special to promote the new Windows 7 operating system, Microsoft jumped at the opportunity: MacFarlane's *Family Guy* has a passionate following among students, many of whom prefer Apple Macs. But Microsoft's marketing team didn't take into account how MacFarlane's off-color sense of humor would jibe with its brand. After reviewing scripts and a raunchy taping of the special in mid-October, Microsoft abruptly canceled the deal. |BW|

BUSINESSWEEK.COM | To see a video report featuring some of the customized commercials produced by TV networks for brands like Microsoft, go to businessweek.com/go/09/ads



# “I used to think it was just a phase, until I had ‘the talk’ with my doctor.”

## Your Doctor Talks to Men About ED Every Day

Actually, erectile dysfunction (ED) is more than just a phase. It’s a common medical condition affecting millions of men just like you. But your doctor can help.



Doctor portrayal.



## Keys to Opening Up to Your Doctor

The hardest part about having ‘the talk’ is getting those first few words out. Here are some ideas to help you break the ice when your doctor asks how everything’s going:

The Direct Approach:
“I have trouble sometimes in bed. Could it be ED?”

The Indirect Approach:
“Is it true age affects sexual performance?”

The Silent Approach:
Just hand this ad to your doctor, he’ll take it from there.

## Running the Numbers

Did you know half of all guys over 40 have some form of ED? Here are some numbers to keep in mind from a recent survey of men with ED:

**71%** of men were anxious about talking to their doctor about ED.

**89%** of men felt relieved after talking to their doctor.



## Tell Me More

To learn more about VIAGRA for the treatment of ED, and ED in general, visit **viagra.com** today. You’ll find an online sexual health quiz, videos of guys with ED who’ve had the VIAGRA Talk and other helpful information.

Over 20 million men have already had their VIAGRA Talk. Isn’t it time you had yours?

## Important Safety Information

We know that no medicine is for everyone. Don’t take VIAGRA if you take nitrates, often prescribed for chest pain, as this may cause a sudden unsafe drop in blood pressure.

Talk with your doctor first. Make sure your heart is healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away.

In the rare event of an erection lasting more than four hours, seek immediate medical help to avoid long-term injury.

In rare instances, men who take PDE5 inhibitors (oral erectile dysfunction medicines, including VIAGRA) reported a sudden decrease or loss of vision, or sudden decrease or loss of hearing. It is not possible to determine whether these events are related directly to these medicines or to other factors. If you experience any of these symptoms, stop taking PDE5 inhibitors, including VIAGRA, and call a doctor right away.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time.

VIAGRA does not protect against sexually transmitted diseases including HIV.

Please see Important Facts for VIAGRA on the following page or visit viagra.com for full prescribing information.

**For free information, including questions to ask your doctor, call 1-888-4VIAGRA (1-888-484-2472).**

VIAGRA®
(sildenafil citrate) tablets

*You are encouraged to report negative side effects of prescription drugs to the FDA. Visit www.FDA.gov/medwatch or call 1-800-FDA-1088.*

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# IMPORTANT FACTS

VIAGRA® (sildenafil citrate) tablets (vi-AG-rah)

## IMPORTANT SAFETY INFORMATION ABOUT VIAGRA

Never take VIAGRA if you take any medicines with nitrates. This includes nitroglycerin. Your blood pressure could drop quickly. It could fall to an unsafe or life-threatening level.

## ABOUT ERECTILE DYSFUNCTION (ED)

Erectile dysfunction means a man cannot get or keep an erection. Health problems, injury, or side effects of drugs may cause ED. The cause may not be known.

## ABOUT VIAGRA

VIAGRA is used to treat ED in men. When you want to have sex, VIAGRA can help you get and keep an erection when you are sexually excited. You cannot get an erection just by taking the pill. Only your doctor can prescribe VIAGRA.

VIAGRA does not cure ED.

VIAGRA does not protect you or your partner from STDs (sexually transmitted diseases) or HIV. You will need to use a condom.

VIAGRA is not a hormone or an aphrodisiac.

## WHO IS VIAGRA FOR?

Who should take VIAGRA?

Men who have ED and whose heart is healthy enough for sex.

Who should NOT take VIAGRA?

- If you ever take medicines with nitrates:
  - Medicines that treat chest pain (angina), such as nitroglycerin or isosorbide mononitrate or dinitrate
- If you use some street drugs, such as "poppers" (amyl nitrate or nitrite)
- If you are allergic to anything in the VIAGRA tablet.

## BEFORE YOU START VIAGRA

**Tell your doctor if you have or ever had:**

- Heart attack, abnormal heartbeats, or stroke
- Heart problems, such as heart failure, chest pain, or aortic valve narrowing
- Low or high blood pressure
- Severe vision loss
- An eye condition called retinitis pigmentosa
- Kidney or liver problems
- Blood problems, such as sickle cell anemia or leukemia
- A deformed penis, Peyronie's disease, or an erection that lasted more than 4 hours
- Stomach ulcers or any kind of bleeding problems

**Tell your doctor about all your medicines.** Include over-the-counter medicines, vitamins, and herbal products. Tell your doctor if you take or use:

- Medicines called alpha-blockers to treat high blood pressure or prostate problems. Your blood pressure could suddenly get too low. You could get dizzy or faint. Your doctor may start you on a lower dose of VIAGRA.
- Medicines called protease inhibitors for HIV. Your doctor may prescribe a 25 mg dose. Your doctor may limit VIAGRA to 25 mg in a 48-hour period.
- Other methods to cause erections. These include pills, injections, implants, or pumps.

## POSSIBLE SIDE EFFECTS OF VIAGRA

Side effects are mostly mild to moderate. They usually go away after a few hours. Some of these are more likely to happen with higher doses.

**The most common side effects are:**

- Headache
- Feeling flushed
- Upset stomach

**Less common side effects are:**

- Trouble telling blue and green apart or seeing a blue tinge on things
- Eyes being more sensitive to light
- Blurred vision

**Rarely, a small number of men taking VIAGRA have reported these serious events:**

- Having an erection that lasts more than 4 hours. If the erection is not treated right away, long-term loss of potency could occur.
- Sudden decrease or loss of sight in one or both eyes. We do not know if these events are caused by VIAGRA and medicines like it or caused by other factors. They may be caused by conditions like high blood pressure or diabetes. If you have sudden vision changes, stop using VIAGRA and all medicines like it. Call your doctor right away.
- Sudden decrease or loss of hearing. We do not know if these events are caused by VIAGRA and medicines like it or caused by other factors. If you have sudden hearing changes, stop using VIAGRA and all medicines like it. Call your doctor right away.
- Heart attack, stroke, irregular heartbeats, and death. We do not know whether these events are caused by VIAGRA or caused by other factors. Most of these happened in men who already had heart problems.

If you have any of these problems, stop VIAGRA. Call your doctor right away.

## HOW TO TAKE VIAGRA

Do:

- Take VIAGRA only the way your doctor tells you. VIAGRA comes in 25 mg, 50 mg, and 100 mg tablets. Your doctor will tell you how much to take.
- If you are over 65 or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg).
- Take VIAGRA about 1 hour before you want to have sex. VIAGRA starts to work in about 30 minutes when you are sexually excited. VIAGRA lasts up to 4 hours.

Don't:

- Do not take VIAGRA more than once a day.
- Do not take more VIAGRA than your doctor tells you. If you think you need more VIAGRA, talk with your doctor.
- Do not start or stop any other medicines before checking with your doctor.

## NEED MORE INFORMATION?

- This is only a summary of important information. Ask your doctor or pharmacist for complete product information OR
- Go to **www.viagra.com or call (888) 4-VIAGRA (484-2472).**

Uninsured? Need help paying for Pfizer medicine? Pfizer has programs that can help. Call **1-866-706-2400** or visit www.PfizerHelpfulAnswers.com.

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VGIF Rev 4 12/07

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**Oakland Wal-Mart: Will new rules in California cause shoppers to buy in other states?**

KIMBERLY WHITE/REUTERS/CORBIS

# HASTA LA VISTA, POWER-HUNGRY TVs

**California is set to outlaw flat-screen models that soak up energy. Manufacturers and merchants are fuming**

**By Cliff Edwards**

How green is your TV? If you're like most people, you have no idea how much energy your television uses. Yet as screens have grown bigger in recent years, the amount of electricity gobbled up by TVs has soared. The trend worries some regulators and utilities. They say big-screen energy hogs are taxing the power system and consumers are unwilling to buy energy-efficient sets since they often cost several hundred dollars more.

California plans to force the issue. As early as Nov. 4, the state is expected to set new guidelines that would require retailers by 2011 to sell only sets that consume about a third less power than they do today. Manufacturers and retailers say the new rules could force them to pull large-screen plasma TVs and many other models off store shelves. But California's Energy Commission says it's confident manufacturers will be able to retool their products to meet the deadline and that tighter standards are necessary.

The cost to power a big-screen TV may not seem high for one family. A 42-inch plasma model turned on for the average 4.5 hours a day uses about $4.50 in electricity a month, or $54 a year. But the extra demand adds up across millions of homes. "If we did nothing, we'd be looking at 38 million people [doubling TV] energy usage in the state by 2020," says Adam Gottlieb, spokesman for the Energy Commission. The commission figures the new standards, which are backed by Governor Arnold Schwarzenegger, would conserve enough electricity by 2013 to power about 864,000 homes annually.

Consumer electronics companies and retailers are up in arms over California's proposed rules. They say that adding new technology to lower energy consumption on TVs will force them to raise prices. That could stop consumers from buying new TVs or send them to the Internet to purchase sets from out of state. In addition, the California mandate may force TV makers to cut back on new features that require additional energy, such as the ability to surf the Web from the TV. "Imposing arbitrary limits deprives the consumer of buying the television they want, at a price that's affordable to each individual," says Douglas Johnson, senior director of technology policy for the Consumer Electronics Assn.

### "SLEDGEHAMMER OF REGULATION"

Johnson says consumers should be able to decide whether they want energy-efficient televisions or not, just like they do with automobiles. He points out that electronics companies already offer a wide variety of energy-saving products. Many consumers do opt to buy sets that meet the Energy Star standard, a federal gauge of energy efficiency that is voluntary rather than mandatory. In fact, 98 out of the 100 best-selling televisions at retailer Best Buy meet the Energy Star standard. "The commission is working with one tool in its toolbox, and that's the sledgehammer of regulation," Johnson says. "We think there are other ways of supporting energy efficiency."

Still, gadget-loving shoppers should be on notice: Big-screen TVs may just be the start. Gottlieb says regulators could impose new power-consumption rules for digital video recorders, game consoles, Blu-ray players, and other gizmos. The reason, he says, is that electronics are gobbling up an increasing amount of electricity, adding up to as much as 10% of the average home's electric bill. Big-screen televisions, Gottlieb says, are just "the low-hanging fruit." |BW|

### THE BIG ENERGY PICTURE

Just how much power do TVs consume?

| SET TYPE | POWER USED |
|---|---|
| 30-in. CRT | 101 watts |
| 42-in. LCD | 204 watts |
| 42-in. PLASMA | 271 watts |

Data: California Energy Commission

# THE GDP MIRAGE

# THE MOST COMPREHENSIVE GAUGE OF U.S. ECONOMIC ACTIVITY IS BROKEN. BY OVERLOOKING CUTS IN RESEARCH AND DEVELOPMENT, PRODUCT DESIGN, AND WORKER TRAINING, GDP IS GREATLY OVERSTATING THE ECONOMY'S STRENGTH

**By Michael Mandel**

Here's a riddle: If a scientist or engineer is laid off, does it affect gross domestic product?

As this story is being written, most economists expect the third-quarter GDP statistics, to be released on Oct. 29, will show a growing U.S. economy, breaking a string of four consecutive negative quarters. A Bloomberg survey pegs the anticipated annualized growth rate at 3.2%, a figure that would be the highest in two years.

This number will likely be greeted as a sign the recession is over. What's more, a rise in GDP, combined with a sharp fall in employment in the third quarter, will imply that productivity also soared during the period. Good news, right?


MANDEL ON ECONOMICS

The trouble is that those GDP and productivity growth figures could be significantly overestimated—perhaps by one percentage point, or even more.

That's because the official statistics mostly overlook "intangible investments" such as business spending on research and development, product design, and worker training. There's ample evidence to suggest that companies, to cut costs and boost short-term profits, are slashing this kind of spending, which is essential for innovation. Without investment in intangibles, the U.S. can't compete in a knowledge-based global economy. Yet you won't see that plunge reflected in the GDP and productivity statistics.

In effect, government statisticians are trying to track a 21st century bust with 20th century tools. Not only is that distorting the critical data that investors, policymakers, and corporate executives use to evaluate the economy, it might also be creating a false sense of relief as Americans battle a brutal recession.

### FRAGMENTARY DATA

Here's a sobering sign that companies are robbing the future to pay for short-term profits: Over the past year, U.S. employment of scientists and engineers—the people who create the next generation of products and make America more competitive over the long term—has fallen by 6.3%, according to a *BusinessWeek* tabulation of unpublished data. Yet overall employment has fallen only 4.1% (chart). "There are really bright people who are struggling to find a job," says Josh Albert, managing director at Klein Hersh International, an executive search firm for life scientists.

That's a big problem, because the output of such well-educated workers has become an increasingly important part of the U.S. economy in recent years. New research by Carol Corrado of the Conference Board and Charles Hulten of the University of Maryland, to be presented at the annual meeting of the American Economic Assn. in January, suggests intangible business investment came to roughly \$1.6 trillion in 2007, compared with roughly \$1.2 trillion spent on tangible assets such as machinery and buildings. In 1995 the two were

BRAD TRENT



roughly equal. Going back even further, tangible investments in 1985 were about 40% larger than intangibles.

The Bureau of Economic Analysis, the government agency that compiles the GDP figures, is taking steps to deal with the new realities. Software has been treated as investment since 1999, and the BEA plans to include R&D in the official GDP statistics in 2013, four years from now. But the agency acknowledges that other areas of intangible investment still need to be worked into the numbers. "We think it's important not to ignore the fact that R&D is only part of broader innovative activity," says BEA Director J. Steven Landefeld. For now, though, the U.S. is navigating through the downturn with fragmentary information.

While the statistics don't account for it, there's good reason to suspect intangible investments are falling. Companies are under pressure to cut costs by reducing R&D expenditures and deferring other crucial intangibles, notes Hulten. "Because these are expensed, it looks like a pure win," he says. "You are not seeing the benefits of the intangibles in the financial statements—only the costs."

**SCARCE VENTURE CAPITAL**

At the same time, companies, especially those in the pharmaceutical industry, are offshoring more research to China, India, and elsewhere. And plain old fear is paralyzing some companies, says Michael R. Englund, chief economist at Action Economics in Boulder, Colo. They don't want to commit to costly investments if the economy remains weak.

One clear-cut sign that GDP growth is being overestimated: the sharp drop in venture capital investment, which goes directly to new businesses. VCs invested about $12 billion in the first three quarters of 2009, barely half the $22 billion plunked down during the first three quarters of 2008. Some of this shortfall would have been spent on computers and other physical equipment, which would have been picked up in GDP. But most of the drop in VC money would have gone to pay for scientists, engineers, and new product development—all valuable intangible investments that show up nowhere in the published stats.

Similarly, many companies have taken a deep ax to their reported R&D spending, which also doesn't show up in GDP (chart). Alcoa, in an effort to preserve cash, reduced its R&D spending by 36% in the third quarter of 2009, compared with a year earlier. "It's a matter of focusing on your priorities," says Alcoa spokesman Kevin Lowery. "We surprised people by announcing a profit [last] quarter." Texas Instruments, meanwhile, expects to spend $1.5 billion on R&D in 2009, down 20% from 2008, owing to workforce reductions and cost-control efforts. And Johnson & Johnson has reduced its R&D by 13% over the past year.

Adding to the uncertainty, companies report their R&D only on a global basis, not broken out by country. As a result, even though some companies are adding to their R&D spending, there's no way to know how much of those increases are taking place in the U.S. (A new survey of business R&D by the National Science Foundation, now under way, will help answer some of these questions, with the first results expected in mid-2010.)

The stimulus package passed in February did include extra

## THE PROBLEM WITH THE NUMBERS

**Reported GDP jumps ahead of jobs... ...but the GDP stats don't count R&D cuts... ...or lost jobs for knowledge workers**

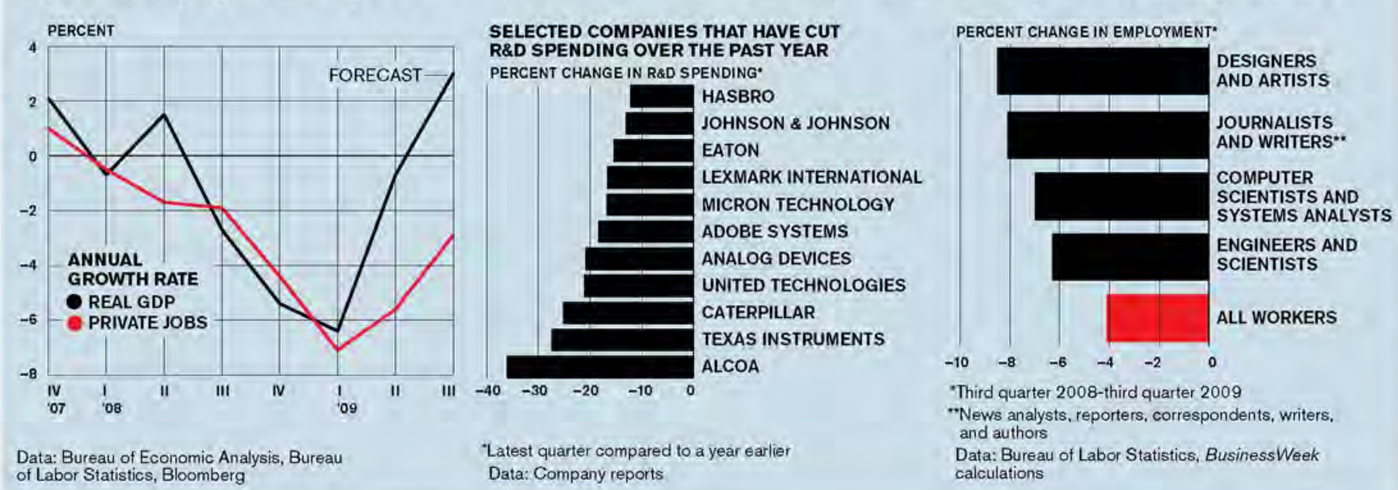



CHART BY LAUREL DAUNIS-ALLEN/BW



Shellabarger, a product development engineer, was let go by Autoliv

PHOTOGRAPH BY MICHAEL NEMETH/WONDERFUL MACHINE

government funds for R&D. However, even with this bump, a just-released analysis by the Democratic Leadership Council suggests total real spending on U.S. R&D is falling for the second straight year, as the business sector cuts back.

To get a handle on the changes in intangible investment, let's focus on the labor market for knowledge workers. It's not a pretty sight. In the manufacturing sector, nonproduction jobs—which include engineers, scientists, and other knowledge workers—declined at a 7.6% annual rate during the third quarter, almost twice as fast as the loss of production workers. The disparity is particularly acute in such key industries as computers and electronic products, transportation equipment, and chemicals. In the chemical industry, which includes pharmaceuticals, the nonproduction workforce is being reduced three times faster than the ranks of the production workers.

**NEGLECTING NEW PRODUCTS**

"The job market just dried up like you wouldn't believe," says Craig Eyermann, a 41-year-old mechanical engineer in Phoenix who was let go from his job at TRW Automotive in February 2009. Besides his master's degree in engineering, Eyermann also has an MBA, can write (he runs the Political Calculations blog), and has experience in a variety of industries, including aerospace and transportation. Despite his skills, the job search has been difficult. Says Eyermann: "There have been a very large number of job postings that simply evaporated over the past several months, as the work upon which they were based has failed to materialize."

One big problem not reflected in the GDP statistics is that companies are retreating from development of new products, especially in stressed industries. Richard Shellabarger, 59, was a product development engineer in Auburn Hills, Mich., for Autoliv, a Swedish-American maker of seat belts and air bags based in Stockholm. Before being let go in February he was working on the "next generation air bag." "I was trying to anticipate what the customer needed," he says. In retrospect, Shellabarger worries that product development wasn't a good place to be in a downturn. "I suppose if you are looking to cut personnel, you don't want to short an area where you are delivering to customers right now," he reflects.

Shellabarger's former employer, Autoliv, cut its global research, development, and engineering staff by 10% from the third quarter of 2008 to the third quarter of 2009. The main reason for the job decline was a reduction in the contract work Autoliv did for automakers, according to Mats Ödman, the vice-president for corporate communications. "As a result of the crisis, [automakers] said, 'We're not going to develop many new models.' There is a lag effect here, and that is catching up now for us." At the same time, Autoliv cut its own R&D budget by 20% in the first nine months of 2009, compared with the same period in 2008.

Shellabarger has a bachelor's degree in mechanical engineering technology. But even a PhD in organic chemistry didn't protect Shawn Kerrick from losing his job in April at Eastman Chemical in Kingsport, Tenn. "I was the only PhD in my area of the company," says Kerrick, 43. A richer pedigree "puts a target on your back," he says.

R&D isn't the only type of intangible investment that seems to be declining. U.S. companies spend an enormous amount on worker training—$134 billion worldwide—but they have been cutting back. The drop started in 2008, when employers reduced their per-worker "learning expenditures" by 3.8%, according to the American Society for Training & Development. No data are available for 2009, but "from anecdotal evidence, obviously there's a lot of cutback," says Pat Galagan, executive editor of publications.

Ideally, a big burst of training would occur during a period of creative destruction such as this so that people can acquire the skills needed for the jobs of the future. The problem is how to pay for that training, since unemployed people don't dare spend money on long-term training when they're worried about short-term survival.

On a positive note, some alternate sources of training are

**A BURST OF RETRAINING SHOULD ACCOMPANY A PERIOD OF CREATIVE DESTRUCTION, BUT COMPANIES HAVE LIKELY CUT BACK ON WORKER TRAINING**

emerging. Autodesk, maker of AutoCAD, has started allowing unemployed architects, artists, designers, and engineers to download free student versions of many of its products to help them keep their skills sharp while they're out of work. "Just fill out a form and say you're unemployed," says Ken Bado, Autodesk's executive vice-president for sales and services. So far, Autodesk says it has about 11,000 participants, who also receive free or greatly discounted classroom training on using the software.

**MEASURING INTANGIBLE INVESTMENTS COULD MAKE AN ENORMOUS DIFFERENCE IN HOW COMPANIES AND INVESTORS VIEW THE ECONOMY**

Governments, too, are stepping up funding of training. Stony Brook University, part of the State University of New York, recently tapped federal stimulus funds to begin training displaced finance professionals for certifications in fields such as project management. "People were banging down our doors," says Patricia Malone, director of corporate training and education at Stony Brook. "We were able to accommodate an unbelievable amount of people in a very short time. The bad news is, we ran out of money very quickly."

### A COMING REVIVAL?

Measuring intangible investments such as business R&D and worker training isn't easy—which is one reason why government statisticians haven't yet done it. But including such expenditures could make a big difference in the way companies, investors, and others understand the economy. Let's do a back-of-the-envelope calculation. In the four quarters ended last June, business spending on tangible investments—equipment and structures—as reported by the BEA fell by about 20%. If intangible investments had dropped at the same rate, it might have knocked an additional 1.5 percentage points off the −3.8% GDP growth rate. If intangibles fell by only 15%, that might have taken 1 percentage point off GDP growth. (These calculations require making heroic assumptions about price changes and other difficult-to-observe figures, so they should be treated as very rough estimates.)

Since manufacturers are still cutting nonproduction workers, there's a high likelihood that intangible investment was still plunging in the third quarter. That suggests GDP and productivity growth in the third quarter could be overstated by one percentage point, and perhaps more.

Will intangible investments revive soon? Albert of Klein Hersh notes that some companies are starting to hire biologists again. "It's the beginning stages of commitment to discovery," he says. But that uptick is likely to be negated by two massive mergers in the pharma sector, which will result in huge layoffs and cuts in R&D spending. The hookup of Pfizer and Wyeth closed on Oct. 15, and the merger of Merck and Schering-Plough is expected to close sometime in the fourth quarter.

Another major trend that will affect intangible investment in the U.S.: outsourcing of R&D to China, India, and other countries. "Companies want us to recruit foreign nationals from the U.S. to work overseas," says Albert. In effect, more and more of the global R&D dollar is being spent abroad, so imports of R&D are increasing.

This shift in intangible investment is also not well tracked by the GDP statistics, although it obviously will depress employment of scientists and engineers in the U.S. But the economic impacts are murky. Corporate executives have argued that shifting R&D to China and India benefits the U.S. by improving the efficiency of the research process. If you can pay two trained scientists in China the same amount as one in the U.S., they say, you can get twice as much research output. However, if U.S.-based companies are doing their research and product development overseas, and their production there as well, it's tough to see how ordinary workers in the U.S. will gain.

But that's another story. For now, it's enough to note that the difficult environment for knowledge workers means the GDP statistics are sending too rosy a message about the economy. And as the old saying goes, "If you can't measure it, you can't manage it." Until that situation improves, it's going to be difficult to know if the U.S. is really on the road to recovery. |BW|

*–With Peter Coy in New York*

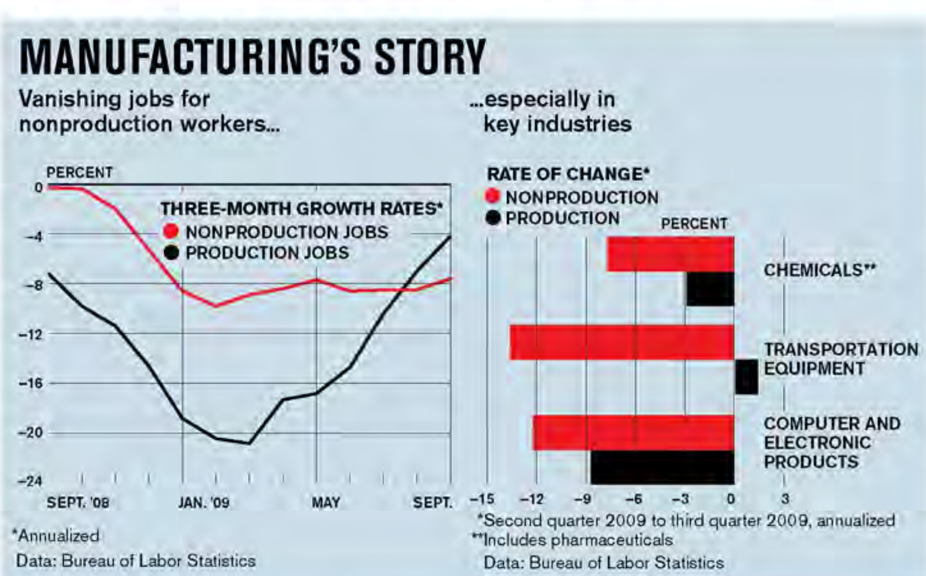
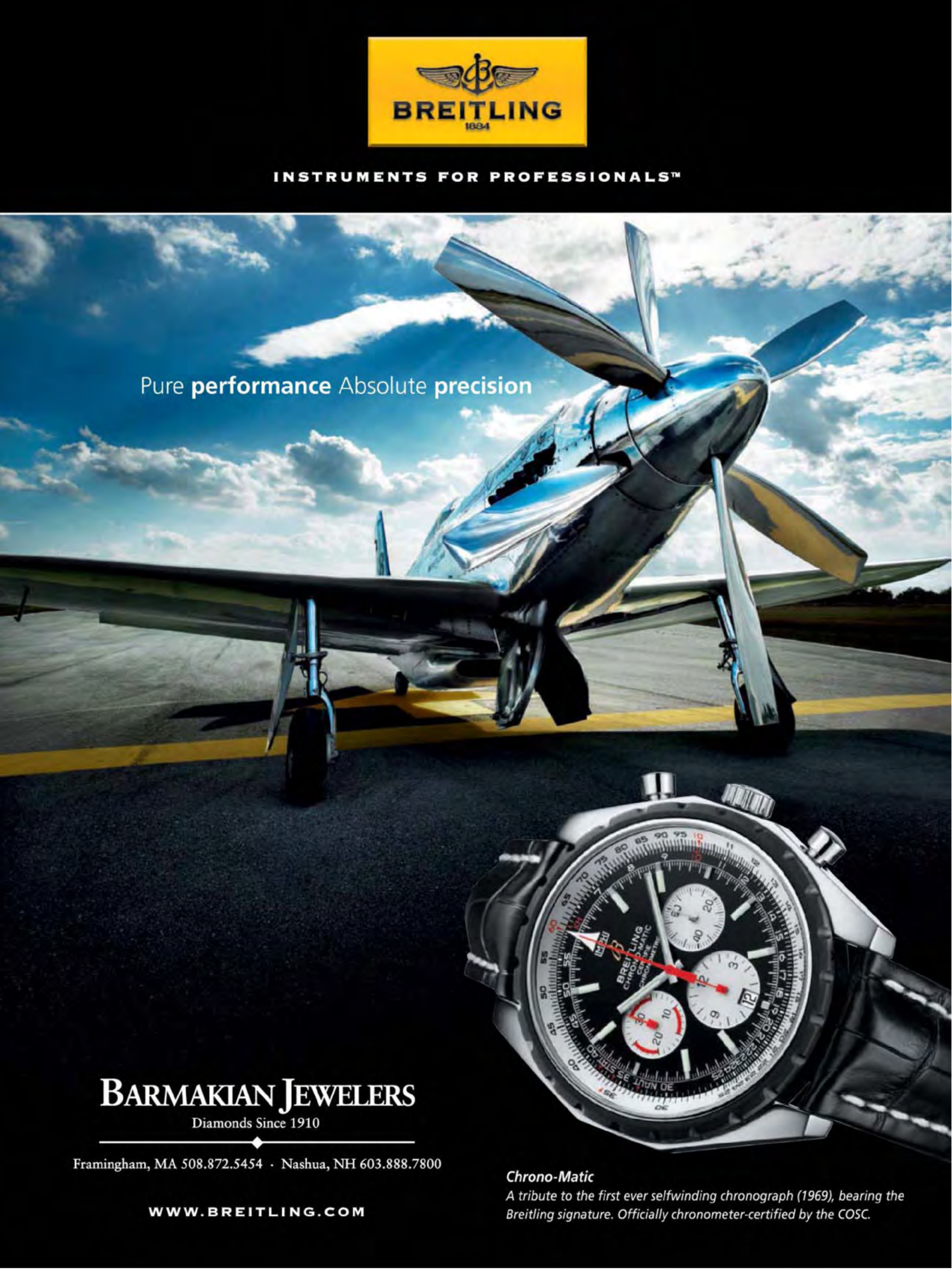
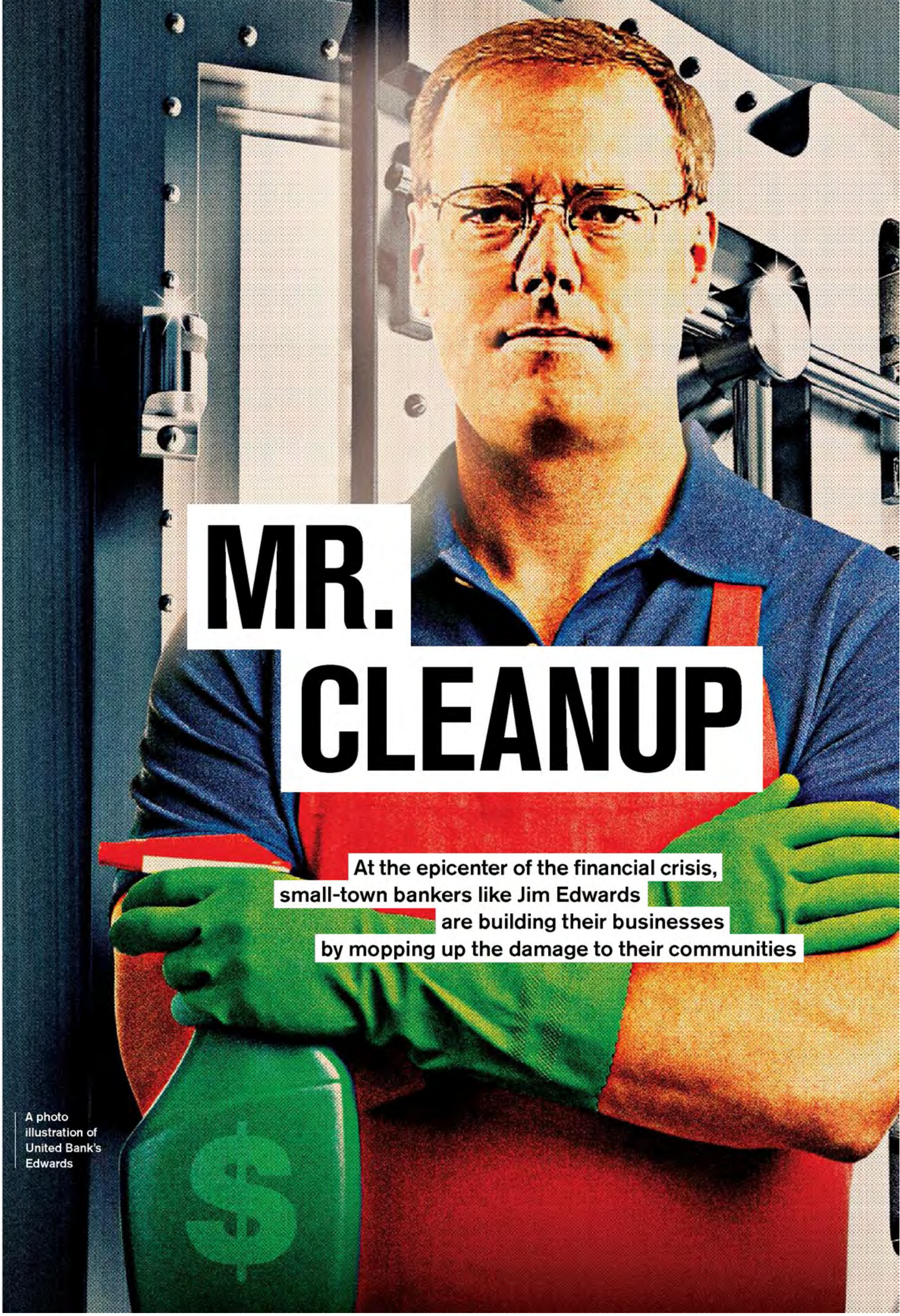



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# MR. CLEANUP

At the epicenter of the financial crisis, small-town bankers like Jim Edwards are building their businesses by mopping up the damage to their communities

A photo illustration of United Bank's Edwards



ILLUSTRATION BASED ON PHOTO BY ANN STATES

**By Peter Carbonara**

**Photo illustration by Sean McCabe**

Georgia's financial crisis is making accidental heroes out of people like Jim Edwards. The 44-year-old Edwards is CEO of United Bank, a small, family-controlled outfit based in Griffin, about an hour's drive south of Atlanta. Late last year he began to turn United's sleepy headquarters into a hotbed of dealmaking, at least by the standards of suburban Georgia. At the invitation of regulators, Edwards in December took control of First Georgia Community Bank in Jackson, one county to the east. Last month he acquired First Coweta Bank, 45 minutes to the west of Griffin, making United the only bank in the state to buy two failing neighbors.

Edwards emphasizes that the deals were nothing more than opportunities to expand at bargain prices. But they were also acts of public service, if unintentionally. United's arrival in Jackson and Coweta reassured frightened depositors, kept most bank employees in their jobs, and made it possible for two institutions that had lumbered along for months as virtual zombies to resume lending to good customers. "It was really stressful for employees and customers," says Edwards, "They really welcomed us."

Regulators need many more people like Edwards to help clean up America's banking mess. While some big lenders are returning to profitability, the Federal Deposit Insurance Corp. and other government agencies are still very much in crisis mode. Some 106 banks have failed in the past year across the U.S., and 416 others are on the government's watch list.

With its cash reserves depleted from all the recent seizures, the FDIC is desperately looking for healthy banks to buy troubled ones, or at least some of their assets. If it can't find buyers, it will be forced to shutter banks and write checks to depositors for up to $250,000 apiece. That requires massive outlays; it could also lead to years of economic stagnation in the affected regions, with capital-starved businesses and consumers competing for scant loans.

Nowhere is the task before regulators more difficult than in Georgia. California and Florida may garner more headlines, but the Peachtree State is the Bank Failure Capital of America, accounting for 20 of the nation's 106 blowups. By one commonly used measure, the so-called Texas ratio of bad loans to total assets, 49 other Georgia banks, about one in six, are in imminent danger.

Georgia leads the nation in bank failures partly because it has so many banks: There's one for every 29,000 citizens, among the highest concentrations in the U.S. An antiquated law in place until 1996 protected local Georgia banking monopolies by making it difficult for a lender based in one of the state's 159 counties to open a branch in another. As a result, Georgia has always been glutted with small banks: Despite the recent failures, the state still has 309 of them.

Yet most of Georgia's problems are limited to a 50-mile radius around Atlanta, a region now known to regulators,

# THE CIRCLE OF DEATH

**Georgia banks in 2009 that were:**

▼ SOLD TO OTHER BANKS ▼ CLOSED

1 eBank
2 Georgian Bank
3 Omni National Bank
4 Silverton Bank, NA (closed)
5 Neighborhood Community Bank
6 First Coweta Bank
7 Community Bank of West Georgia (closed)
8 American Southern Bank
9 Security Bank of North Metro
10 Security Bank of North Fulton
11 Security Bank of Gwinnett County
12 American United Bank
13 First Piedmont
14 Freedom Bank of Georgia
15 Security Bank of Jones County
16 Security Bank of Bibb County
17 Security Bank of Houston County
18 FirstBank Financial Services
19 FirstCity Bank (closed)
20 Southern Community Bank

Data: FDIC




bankers, and realtors as the Circle of Death. Like other Sunbelt areas—Las Vegas, Phoenix, and the Florida coast—the Atlanta suburbs got swept up in the building boom of the early and mid-2000s. But the banks inside the Circle of Death were more reckless than most.

Anxious to make loans and starved for cash, these tiny banks used a common but little-known tool known as "brokered deposits" to attract out-of-state money. Brokered deposits come in a variety of forms, but usually they're short-term certificates of deposit. In a typical transaction, an independent broker connects a bank with a wealthy investor or institution seeking a high rate of return on cash and FDIC protection, having gone over the $250,000 limit at other institutions. The bank pays the brokers for their efforts. Many deals take place via electronic marketplaces such as QwickRate.com.

The trouble with brokered deposits is that they let banks grow more quickly than their managers can handle. They're also riskier than local deposits: Because owners of brokered deposits have no personal relationship with the bank (no tellers greeting them by name or asking about their kids), they're likely to flee at the first sign of trouble or offer of a better deal.

Brokered deposits helped turn the Atlanta region's building boom into a banking boom. Old institutions expanded and new ones mushroomed: Regulators approved 112 new charters from 2000 to 2007. At some of the banks, brokered deposits accounted for upwards of 50% of their total. "It was very easy," says Edwards. "All you had to do was get on the Internet."

For a while it seemed as though almost anyone could scrape together some capital and open a bank in the Atlanta suburbs. Lawrence White, an economist at New York University, saw a similar pattern when he was a bank regulator involved in the savings-and-loan cleanup in the early 1990s. White says brokered deposits aren't bad per se but adds that "any time you see an organization grow very quickly, you have to worry."

HOW TO PLAY IT 062

"It's like a crowded escalator at the airport," says Joe Brannen, president of the Georgia Banker's Assn., a trade group. "If it stops suddenly, then everybody falls."

**WILLPOWER AND OPPORTUNISM**

Stretched out over an armchair in United's two-story brick headquarters, picking through one of the paper cups of boiled peanuts handed out during a recent Customer Appreciation Day, Edwards reflects on his bargain purchases of the past year. "I don't want it to sound like we're some kind of geniuses," says the third-generation banker. "My dad always told us not to think we were smarter than everybody else." The Edwards clan knows about opportunism: In 1990, when Jim's father, Joe, and uncle, Bill, ran the bank, they bought the building that's now United's headquarters for a pittance from a failed S&L. Their father, Joel, ran the bank before that.

The town of Griffin is a bit too far south of Atlanta to have

DAVID FOSTER

been caught up in the real estate boom. While the surrounding farmland is pocked with new subdivisions, malls, and a seeming oversupply of Dollar General stores, downtown Griffin looks just as a Yankee visitor would expect, its wide main thoroughfare lined with towering shade trees and stately old homes.

Jim Edwards, who graduated from Emory University in 1987 and received his MBA from the University of Virginia in 1993, has long resisted the temptation to expand as quickly as some of the other banks inside the Circle of Death. While those institutions relied heavily on brokered deposits, United steered clear. Last winter that willpower started to pay off.

In December, First Georgia Community Bank, with four branches and $237 million in assets, failed. Founded in December 1996 and based in Jackson, First Georgia had been under the scrutiny of state and federal regulators for years. By 2006 about 50% of the bank's deposits were brokered, much more than the 20% to 30% level that regulators consider a red flag. Moreover, roughly half its total loans were to developers and construction companies, a worrisome concentration. As the real estate bust worsened, federal and state regulators pushed the bank into receivership.

At his office in Griffin, United's Edwards got an e-mail from the FDIC saying First Georgia's deposits and assets were up for bid. Edwards was intrigued for several reasons. United was in growth mode, opening new offices in 2004 and 2007. Being so close to Griffin, Jackson was one of the towns in its sights. And the price was right: United walked away with First Georgia's deposits for 88¢ on the dollar. It also got the option to buy any of First Georgia's loans at face value—it grabbed $60 million worth—and leave the others for the FDIC to deal with.

Nearly a year later those bad loans, many of them made to finance convenience stores and real estate development, continue to be a strain on regulators. "It just got too big, too fast," says Edwards. United is still renting office space at the Jackson branch to FDIC operatives working through the mess.

Yet First Georgia wasn't the Circle of Death's worst disaster. FirstCity Bank, based in Stockbridge, about 30 miles northeast of Griffin, was so rancid by the time potential buyers took a sniff that they passed on everything—even the healthy assets.

Stockbridge is in Henry County, just on the outskirts of Atlanta. An easy commute to downtown or to Atlanta's Hartfield-Jackson Atlanta International Airport, Henry County enjoyed phenomenal growth during the boom. The crash has been correspondingly brutal. Edwards says he has heard bankers with plenty of their own problems joke: "We may have made a lot of bad loans, but at least we didn't lend in Henry County."

FirstCity was a bubble bank like few others. In 2001 a group of local investors including David Everitt, a mortgage broker, bought the charter of the 94-year-old Bank of Gibson, moved the bank's headquarters to Stockbridge, renamed it FirstCity, and devoted the enterprise almost completely to making loans to local builders. By the end of 2008, FirstCity's assets had soared fifteenfold, to $285 million. The bank, run from an office in a mall, supplemented its small base of local deposits with a generous helping of out-of-state money. At the peak, brokered deposits accounted for 67% of FirstCity's capital.

Everitt, a former chairman of the bank, says FirstCity for years had more business than it could handle. But the real estate bust was so sudden and so devastating that loan demand dried up overnight and defaults surged. "It shocked all of us," he says. Everitt claims he lost $6 million in the collapse.

**A QUICK PEEK WAS ALL EDWARDS NEEDED TO TAKE A PASS ON TROUBLED FIRSTCITY BANK. IN THE END, NO ONE WOULD TOUCH EVEN ITS HEALTHY ASSETS**

When banking authorities invited Edwards and others to evaluate FirstCity, he took only a quick peek before passing. Unable to find any bidders, regulators were soon forced to shutter FirstCity and send checks totaling about $100 million for insured deposits to the bank's customers. Two other failed Georgia banks have proven similarly unappetizing to healthy banks, resulting in government payouts of about $1.5 billion.

Edwards wasn't finished trawling for bargains, though. In September he bought Newnan-based First Coweta Bank for $167 million. First Coweta's story is classic Circle of Death: A small community bank grows in a hurry on real estate loans and brokered deposits, then crashes. In June regulators issued a cease and desist order, giving the bank 60 days to clean up its loans and raise new capital—and barring it from taking new brokered deposits or making loans, even to good customers.

Edwards thought there was a decent business amid the wreckage. Regulators asked him and other potential bidders to examine the books discreetly: They slipped into the branch through the back door, having been instructed not to wear clothing bearing bank logos. "They wanted people to think you were an auditor or something," says Edwards.

Regulators, increasingly eager to sell ailing banks, were offering attractive terms. In addition to buying First Coweta's deposits at a discount, United grabbed all of the bank's $105 million in loans under a "loss share" deal: The FDIC agreed to eat the first 80% of losses on those loans, while United is on the hook only for the remainder.

**19%**

**Percentage of U.S. bank failures in the past year that took place in Georgia**

Data: FDIC

Dennis Trimper of the FDIC's Dallas office spearheaded the Friday night seizure and turnover. After the branch closed for the evening, he brought Edwards and his team into the branch through the back door. They quickly began poring over the books. "He was there with about 80 people from the FDIC, and they went right to work basically auditing the bank, so you knew exactly what you were getting when

you opened for business on Monday," says Edwards. "I don't think he slept all weekend, which is pretty amazing for a government employee." Trimper declined to comment.

A sweet deal for Edwards was even sweeter for employees: Of the 40 or so employees of First Coweta, all but five are still with the bank. "I don't think we could have gone out and handpicked a better acquirer," says Harold McCoy, vice-president of retail lending at First Coweta, now United.

United being a family bank, it put John Edwards, Jim's cousin, in charge during the transition. John, 49, is United's chairman. (Two other Edwardses work for United: Jim's younger brother, Chris, is the chief information officer, while John's older sister, Allie, is a lawyer.) John, beefier than Jim and a bit more blunt, has done a good job of bringing First Coweta into the United fold, say employees. One customer, Unity Baptist Church, faced the prospect of losing part of a construction loan that had been arranged by First Coweta. When United took over, John Edwards set up a meeting with the church. "He looked me in the eye and told me this was the first loan United Bank is going to do here in Newnan," says Carey Jackson, 54, a deacon at the church.

Saving two community banks has bolstered Jim Edwards' reputation in the Atlanta suburbs. "He's the man on the white horse," jokes Brannen of the Georgia Banker's Assn. "He shows up and people say, 'Oh, thank God, it's Jim.'"

**LOOKING FOR A SAVIOR**

The bad news for the FDIC and the Georgia economy is that Edwards is done making deals for a while. Integrating the new branches, employees, and assets is consuming all of his time. "I can't say if something came along we wouldn't take a look at it," he offers while cruising in his 11-year-old black Mercedes from Newnan to Griffin. "But for now I think we have enough on our plate."

That means bankers like Pat Shepherd will have to find rescue elsewhere. Shepherd is a founder and CEO of Bank of Georgia, in Peachtree City, which lies between Griffin and Newnan. It's headquartered in a new and nondescript office park just off a highway that's lined with competitors: Regional giants BB&T and Suntrust are just around the corner from Bank of Georgia, while rival Delta Credit Union is a few miles up the road.

In 1999, Shepherd, an effusive and informal career banker with salt-and-pepper hair, hooked up with some other investors, amassed an $11 million grubstake, and opened Bank of Georgia. Building loans were soon fueling fast growth: Between the end of 2003 and this June, the bank's assets more than doubled, to $448 million, with over 85% of its loans in real estate.

Now Shepherd, an avid duck hunter, is fighting to save his bank. In August the FDIC and the Georgia Banking & Finance Dept. placed First Georgia under a cease and desist order. After that, says Shepherd, it was hard to overcome the impression among locals that "Y'all are going down in 60 days."

Shepherd says he's optimistic about the bank's survival but admits his efforts to attract new capital haven't yielded much. He has tried without luck to sell bonds and has talked with private equity firms about acquiring a stake. As for healthy institutions that might be interested in buying his bank outright, he says: "In Georgia, there aren't a whole lot of them." | BW |



Bank of Georgia co-founder Shepherd is scrambling to attract new capital

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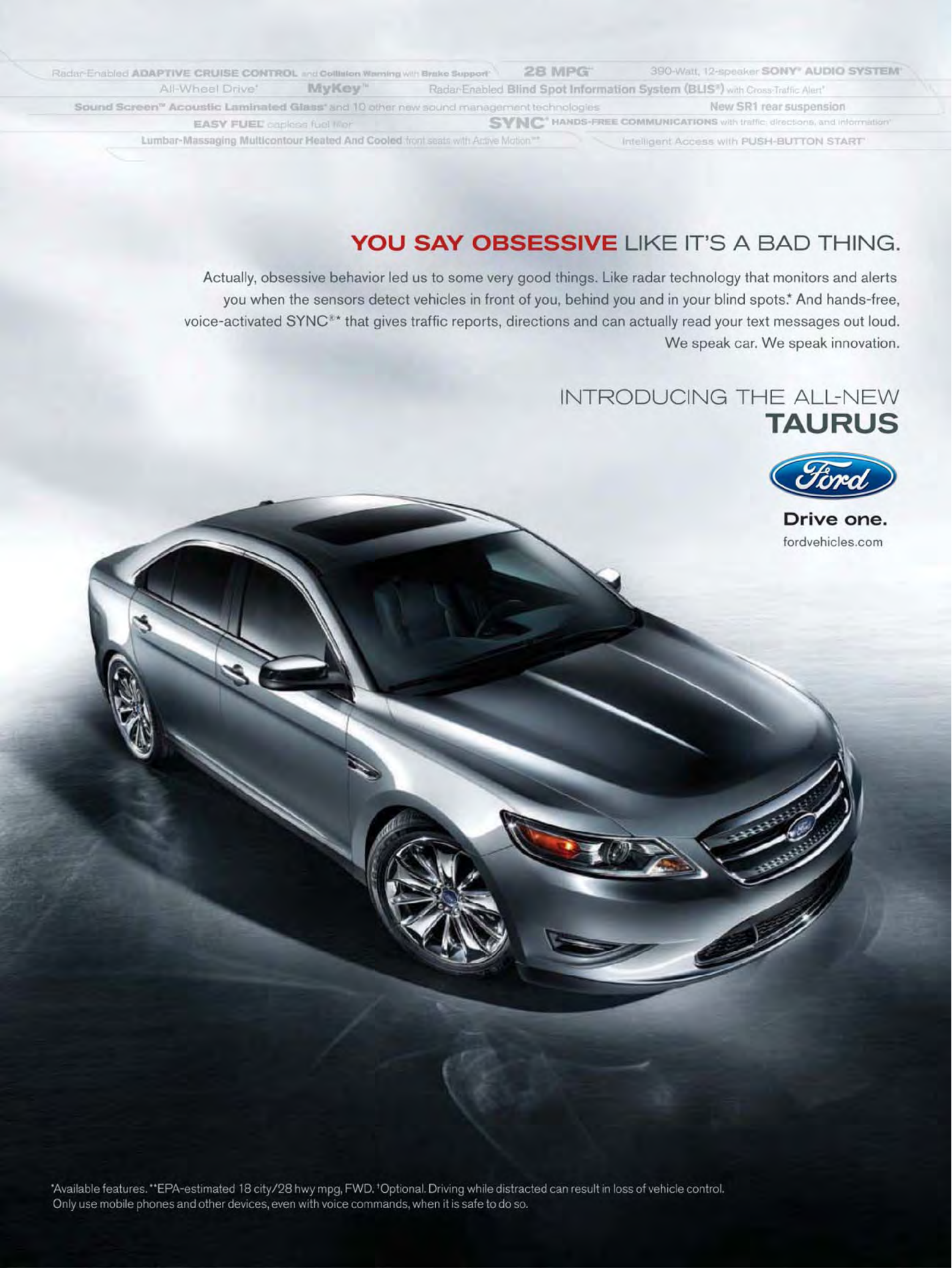
**Business Exchange**

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**Walking Wounded**

The Georgia banks that weathered the collapse of the housing market could yet be knocked out by losses on commercial property loans, wrote Paul Donsky in the *Atlanta Journal-Constitution* on Oct. 17. One sign of trouble: In Atlanta, the retail vacancy rate has risen by almost 50% in the past two years, Donsky reported.

To view the story, go to **http://bx.businessweek.com/banking-industry/reference/**


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# IT'S A BIRD, IT'S A PLANE, IT'S PORK!

By Ben Elgin and Keith Epstein

**Boeing's C-17 cargo aircraft cost $250 million apiece. The Pentagon says it has plenty. But it's nearly impossible for Obama to kill a project that provides jobs in 43 states**

President Barack Obama and Defense Secretary Robert M. Gates want to leave the Cold War in the past—finally—and reshape the U.S. military into more of a counterinsurgency force. They have made reforming weapons acquisition a major priority, saying that some hardware designed for battling Soviet armies or other massive foes in vast open-field clashes ought to be replaced by lighter, less expensive gear. The Administration has pared billions from the budget for the Lockheed Martin F-22 fighter, a super-sophisticated plane conceived in the 1980s for dogfights against Moscow's best. The Pentagon has also reined in a sprawling high-tech infantry project called Future Combat Systems that Boeing oversees. All told, a half-dozen major weapons systems have been eliminated for an estimated savings of more than $100 billion over coming decades.

But it's not like military spending is actually going down. At a projected $107 billion for 2010 alone—a 5% rise over this year—the Pentagon's base budget for planes, ships, missiles, and guns has grown more than 50% since 2000. Reforming and redirecting military procurement always riles members of Congress trying to protect jobs in their home districts. Lawmakers are teaming up with Lockheed, Boeing, and other defense contractors to push back fiercely on certain targeted programs, even when the Pentagon says it doesn't need the weaponry in ques-

STEVEN GEORGES/PRESS-TELEGRAM/CORBIS

tion. In some areas, organized labor has joined the fight.

The C-17 Globemaster offers one illustration of successful opposition to the Obama-Gates push for control of weapons spending. C-17s are large cargo planes produced by Boeing that cost $250 million apiece. They have been used heavily since 1993 to transport troops, tanks, and supplies. Every year since 2006, the Pentagon has said that it has enough C-17s. And every year, Congress overrules the military and authorizes funds for additional planes. In October the Senate approved $2.5 billion in the 2010 budget for 10 more C-17s, which would bring the fleet to 215.



"It's about political engineering," says Mandy Smithberger, a national security staff member of the Project on Government Oversight, a Washington nonprofit. "Companies design weapons systems to make them difficult to kill."

The C-17 by most accounts has served the Pentagon reliably and well. The cavernous Globemaster is flying in both Iraq and Afghanistan. But the real reason Congress wants more of them has little to do with military need. Boeing has built the C-17's industrial base for political survivability.

The company has spread manufacturing across no fewer than 43 states. C-17 production lines employ more than 30,000 workers, many of them relatively well paid by factory-wage standards. Many of those jobs would be at risk if C-17 work ground to a halt.

The White House understands the challenge. "The impulse in Washington is to protect jobs back home, building things we don't need at a cost we can't afford," President Obama said in August in a speech at the Veterans of Foreign Wars Convention in Phoenix. "The special interests, contractors, and entrenched lobbyists—they're invested in the status quo, and they're putting up a fight."

Enthusiasm for the Globemaster crosses political lines. "We're fighting two wars and meeting humanitarian needs; we need these planes," says Senator Kit Bond (R-Mo.). "It is a defense industrial-base issue, too. It produces jobs in 43 states. But that is secondary. We wouldn't push that unless there is a real need." Boeing's defense business has its headquarters in St. Louis.



**Political protection: Boeing turned up the heat on McCaskill (above); Bond had already backed more C-17s**

Bond, Senator Barbara Boxer (D-Calif.), and 16 colleagues began circulating a letter in April urging members of the Senate Appropriations Committee to keep funding the plane despite clearly stated objections from the White House and Pentagon. In California, C-17 production employs 5,000 workers at a final assembly plant in Long Beach.

Bond's fellow Missourian, Senator Claire McCaskill, a Democrat, however, evinced ambivalence in comments to the media earlier this year about earmarking money for more Globemasters. Boeing noted that she didn't sign the letter to the Appropriations Committee. So the company mobilized to change her mind.

The aircraft manufacturer convened a strategy meeting with local labor leaders in mid-spring at its St. Louis offices. George C. Roman, a Boeing vice-president for government operations, helped lead the discussion. A key challenge described by the Boeing side was the need to shore up wavering support from legislators, including McCaskill, according to Robert A. Soutier, president of the Greater St. Louis Labor Council, who attended the gathering.

Shortly after the meeting, Soutier criticized McCaskill in the St. Louis media, questioning her support for thousands of local jobs. McCaskill responded quickly. She defended her C-17 bona fides and in May announced she was sending a letter to Obama and Gates emphasizing her backing for the Boeing cargo aircraft.

Since then, she has showed up at machinist rallies, met Boeing officials, and spoken out forcefully on the plane's behalf. Adrianne Marsh, a spokeswoman for McCaskill, called the earlier discord "a misunderstanding" and says the senator has advocated the program all along. McCaskill "believes the C-17 can stand on its own and compete for these dollars based on its merits," says Marsh.

Soutier says that communication has improved between

## REFORMING THE WEAPONS BUDGET

**White House efforts to curtail military spending have had mixed results. Some examples:**

### C-17 TRANSPORT PLANE
**Lead vendor** – Boeing

**Status** – Congress ordered 10 more at $250 million apiece, even though the Pentagon doesn't want them

### F-22 RAPTOR FIGHTER
**Lead contractor** – Lockheed Martin

**Status** – Funding ceased for additional F-22s, a stealth jet ill-equipped for anti-insurgency fighting

### F-35 FIGHTER 'ALTERNATE ENGINE'
**Lead contractors** – GE and Rolls-Royce

**Status** – Pentagon doesn't want the engine; Congress has allocated $560 million for it anyway

### FUTURE COMBAT SYSTEMS FOR INFANTRY
**Lead contractor** – Boeing

**Status** – The army modernization program was reined in and restructured by the Pentagon

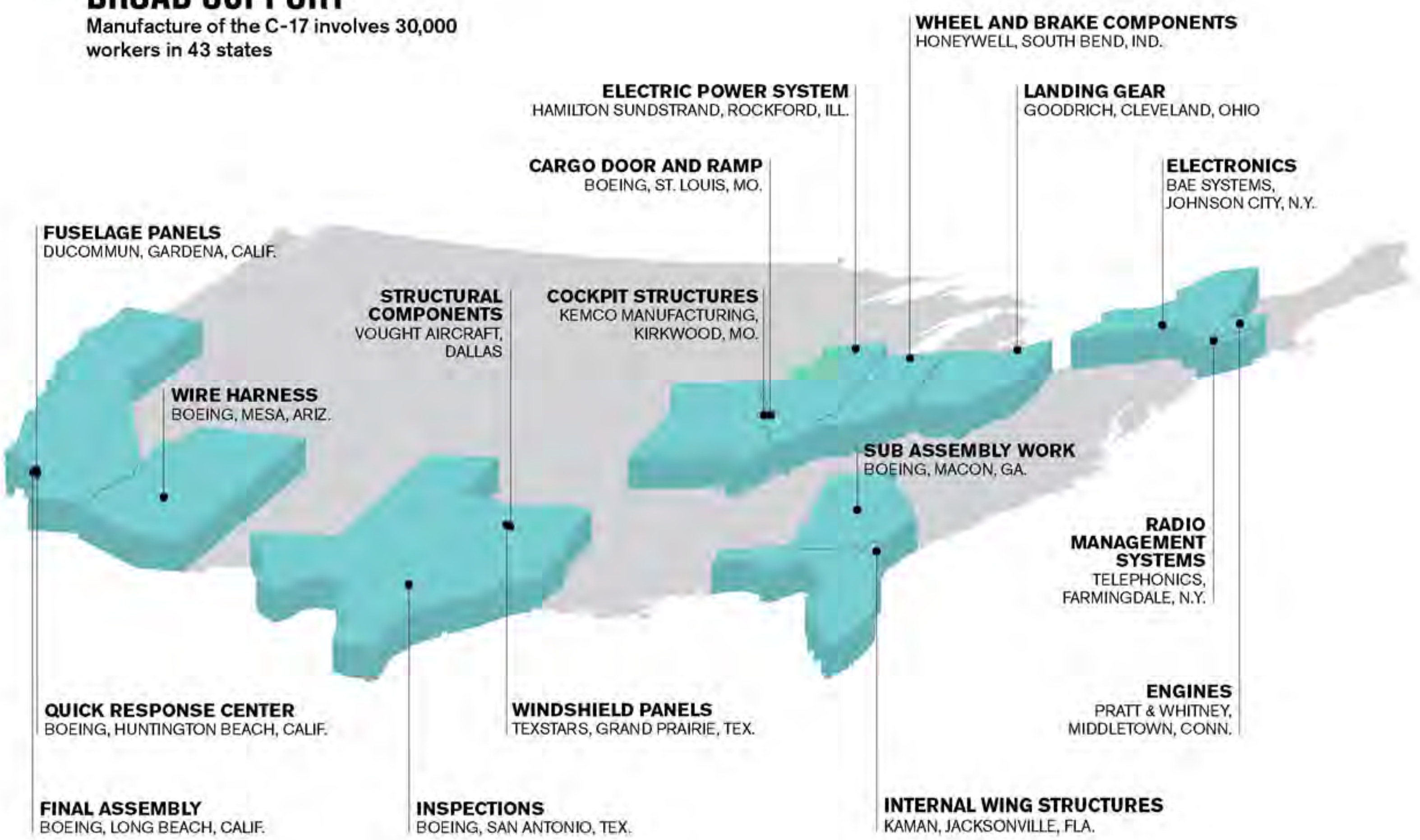
### VH-71 HELICOPTER
**Lead contractor** – Lockheed Martin

**Status** – Pentagon canceled the next-generation Presidential aircraft, which would have cost $400 million each

(TOP TO BOTTOM) PHOTOGRAPHS BY LOUIE PALU/ZUMA PRESS; KELLEY MCCALL/AP PHOTO

## BROAD SUPPORT

Manufacture of the C-17 involves 30,000 workers in 43 states




Boeing and McCaskill and that he's pleased with the senator's support for the C-17. A Boeing spokesman declined to discuss the company's lobbying but said in a prepared statement: "We routinely meet with our employees, their representatives, elected officials, and other key stakeholders to provide updates on our business operations." The spokesman added: "We greatly appreciate the support the C-17 continues to receive. We look forward to continuing to work with both our customer and the Congress to ensure this valuable airlifter is available to support our war fighters and our nation's future airlift requirements."

In late September, as Congress restored money for 10 additional C-17s, the Administration stated that "it strongly objects to" the funding. White House spokesman Thomas Victor told *BusinessWeek*: "The President never thought this was going to be easy, but he and Secretary Gates are committed to pushing for these reforms."

Senator John McCain (R-Ariz.), a prominent critic of Pentagon spending, went to the Senate floor on Oct. 5 to make a last-minute effort to strip funds from the defense budget for the new C-17s. "One would have expected the President and Secretary Gates to be outraged," he said. "However, we have heard barely a word of opposition from them." The next day, McCain's motion was defeated, 68 to 30.

John Murtha (D-Pa.), the powerful chairman of the House Defense Appropriations Subcommittee, said on Oct. 21 that he expects the fiscal 2010 budget to provide for the 10 additional Globemasters. He urged Boeing to trim the price of the plane to about $200 million each, but it remains to be seen whether the manufacturer will lower its bill. |BW|

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**Machinists Throw a Wrench**

While it fights to preserve the Pentagon budget for more C-17 cargo planes, Boeing is struggling with International Assn. of Machinists leaders over a proposed no-strike agreement in connection with the 787 passenger liner. According to the *Seattle Times*, talks are "deadlocked and hindered by distrust on each side." The Machinists have said they would agree to a no-strike deal through 2020 if Boeing guarantees a second 787 assembly line in Everett, Wash., among other conditions, the *Times* reported.

For more on Boeing's labor situation, go to **http://bx.businessweek.com/Boeing/reference/**

GRAPHIC BY NICHOLAS FELTON

## NESTLED BESIDE FOUR GREAT LAKES, YOU'LL FIND ONE IMMENSE TALENT POOL.

Otherwise known as the Ontario workforce: the G7's most educated. 61% are post-secondary graduates. But brainpower is not Ontario's only advantage: Ontario's economic hub, Toronto, is the third largest financial center in North America. And Ontario's low combined federal/provincial corporate income tax rate – lower than the U.S. federal/state average – helps create a cost-effective business environment. All of which make Ontario an ideal business location. That's why **the world works here**.



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## MANAGEMENT & LEADERSHIP

# Disney Remakes The Movie Studio

How CEO Iger is applying the company's brand marketing savvy to filmmaking



ILLUSTRATION BY ANDY FRIEDMAN, BASED ON PHOTOGRAPHS BY REUTERS

**By Ronald Grover**

In early October, Walt Disney Chief Executive Robert A. Iger installed a new chairman at the company's movie studio. Such shakeups are routine in Hollywood, especially now that the entertainment business is struggling. But in hiring as his studio chief Rich Ross, who helped make companywide franchises out of such Disney Channel hits as *Hannah Montana* and *High School Musical*, Iger seems to be reinventing the modern Hollywood studio. "The primary responsibility" of any movie executive, Iger said at a public event recently, is to "choose good movies." But he also expects his studio executive "to be a brand manager."

Iger's philosophy is one that a Procter & Gamble, say, would instantly recognize: build a stable of brands, each with its own strong identity and core group of customers. Since becoming CEO four years ago, Iger has brought inside the Disney tent a handful of marquee names—among them director Steven Spielberg and his DreamWorks SKG team, animation giant Pixar, and Marvel Entertainment. That bolsters a studio that already has Hollywood's biggest brand, Disney, and superstar producer Jerry Bruckheimer, who created such blockbusters as the *Pirates of the Caribbean* series.

Managing these big names and keeping them from undermining one another will be a challenge. But Rick Sands, a former MGM chief operating officer, calls Iger's strategy "pure genius" at a time when "you need well-known filmmakers who can create event films" that stand out amid the clutter of entertainment choices.

### GIVING UP CONTROL

Studios in the past have tried to line up hitmakers, often signing them to "first look" agreements that give the studio dibs on new projects. But most films were funneled through a studio's creative executives, who often found the project and supervised the script. Ross will green-light projects and set in motion many of the 16 films Disney makes each year. But when a studio brings in famous moviemakers such as Spielberg, it's banking on their ability to continue to work their magic. That means giving up some control.

Ross essentially operated that way



Disney boss Bob Iger

at the Disney Channel. He allowed the creative folks to take the lead for *Hannah Montana* and *High School Musical*. Then he got deeply involved in marketing strategy. Before the first *Hannah Montana* episode aired, Ross took its young star, Miley Cyrus, on an internal road show, visiting other Disney units and enlisting them to sell merchandise that helped make the show a hit.

He is expected to be similarly hands-on at the movie studio. Bruckheimer recently showed Ross a 30-minute segment of next year's live-action version of *The Sorcerer's Apprentice*, and says Ross suggested "a dozen ways to market it before he left the room."

### BIG OPENING WEEKENDS

Each brand will require a different management approach. Disney and Pixar executives already sit on a committee that decides which animated projects Pixar should pursue. The committee gives wide latitude to the wishes of Pixar's creative guru, John Lasseter. Spielberg and his DreamWorks partner, Stacey Snider, arrange financing and make their own creative decisions. Disney will provide marketing support. How Marvel will fit into the strategy has yet to be determined, although Iger has said publicly that it will enjoy a lot of autonomy.

From Iger's perspective, the beauty of controlling the rights to movies made by Spielberg, Pixar, and Marvel is that they become events in and of themselves, with lavish press coverage and Web chatter that all but guarantees a big opening weekend. "When you settle into your seat for a Marvel film, you know immediately it's going to be a fun ride," says Avi Arad, the former Marvel Studios CEO who produced *Spider-Man* and other films. Marketing is by far the fastest-growing expense for most studios: It can cost $50 million or more to open a major film. The prerelease buzz from a Spielberg or Marvel film could help rein in marketing costs at a studio that lost money in its most recent quarter.

If films by Disney's stable of brands become hits—and their track records are pretty good—they also will generate hefty revenues from DVDs, merchandise, and theme-park rides. Under the deal with Spielberg, Disney gets 10% of a film's revenues from its theatrical and DVD sales for distributing four to six DreamWorks films a year. It also gets first shot at the rights to sell toys, consumer products, and video games. (Theme-park rights are committed to NBC Universal.) Plus, Disney can package lesser films with the Spielberg or Marvel flicks and charge cable channels and foreign networks more to air them, says former MGM executive Sands.

No question, Iger's brand strategy will put Ross' diplomatic skills to the test. Soap bars and hand creams don't have egos or demand a cut of the profits. Spielbergs and Bruckheimers do. They also will be jockeying for attention and money. "There is only one July 4th, one Christmas," says a Hollywood veteran. "What do you tell Steven Spielberg when Disney gives the [opening] date he wants to Marvel? And what do you tell Bruckheimer when he hears that they've spent more to market a DreamWorks film than one of his?"

Clearly Iger believes the box office boost will be worth all the trouble. At a time when studios are reducing risk by making fewer movies, he is betting on household names with an established record of turning blank pages into billion-dollar franchises. | BW |

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**Digital Kingdom**

Walt Disney is embracing the concept of the cloud. In November the company will unveil a technology code-named Keychest that would allow people who purchase a Disney movie to play it back on multiple gadgets, whether a PC, a TV hooked up to cable, or a cell phone, reported *The Wall Street Journal* on Oct. 21. Disney also has been shopping Keychest to movie studios and tech companies in an effort to get others to sign on.

To view the story, go to **http://bx.businessweek.com/movie-industry/reference/**

# Smithfield: Not Living So High on the Hog

## The meat packer is struggling to overcome the specter of swine flu and a U.S. glut of pigs



**By Nanette Byrnes**

It's flu season again—bad news for Smithfield Foods, the world's largest producer of pork. Six months ago, fears that the H1N1 strain might have originated at one of Smithfield's joint-venture facilities in northern Mexico put the company into crisis mode. Eventually the Mexican government determined there was no connection to the Smithfield (Va.) company's farms, but critical global markets for its products remained closed. And the Oct. 19 announcement that a Minnesota pig was the first in the country to have contracted the H1N1 virus, first called swine flu after early genetic tests suggested a link to pigs, could set off false fears of a link to human illness.

Those concerns come at a particularly vulnerable time for Smithfield. The company had record sales last year of $12.5 billion. But a substantial overabundance of pigs across the U.S. and rising corn prices have put Smithfield and its rivals in a position where they lose an average of nearly $23 on every hog sold to be butchered. The result: a $190 million loss in the year ended May 2009—Smithfield's first in 37 years. It lost a further $108 million last quarter.

CEO C. Larry Pope has taken steps to minimize the damage. He cut his own sow herd 13% over the past year, a big move for a company that controls almost a third of the U.S. market. He did an expensive restructuring of $1 billion in debt and sold $850 million worth of high-interest notes earlier this year after the company was in violation of its loan covenants. Not everyone has cheered all his moves: Two board members, themselves sizable stockholders, quit in protest when he issued $300 million in new equity.

Now Pope is trying to ramp up overseas sales, which account for 9% of revenue. That strategy is complicated by China's having cut off imports of U.S. pork products. While the ban is officially in response to flu concerns, Pope argues that the true motivation is political, a desire to protect China's domestic farmers.

Smithfield already operates throughout much of Europe, which consumes more pork than the U.S. But the big prize is China, which devours about half the world's supply. Smithfield's mainland sales picked up in the first half of 2008 when disease and natural disasters hurt domestic Chinese hog production. To help build market share, Pope sold a 5% stake in Smithfield to Chinese agribusiness giant COFCO in July 2008 and put its chairman, Gaoning Ning, on his board. Since 2002 he has also run a joint venture in China called Maverick Food. "Five or 10 years from today, you'll look back and think. 'That was a smart move,'" says Pope. Having traveled to China, he has found the process of relationship building to be slower than he'd like.

**Citing swine flu, China has cut off U.S. imports. That hurts, because China consumes half the world's pork**

### FATTENING MARGINS

Back home, Pope is trying to rely increasingly on more profitable processed-pork products, which make up 45% of sales. He is reducing Smithfield's portfolio from more than 100 brands to a core group of key names, focusing on such brands as Armour and John Morrell. He has also closed five plants and pushed salespeople to get more of Smithfield's smoked bacon, ham, and baby back ribs into retailers such as Wal-Mart Stores and restaurants like McDonald's and Applebee's. Instead of selling processed pork almost at cost to move product, Pope has also insisted on the simple goal of getting 10¢ of profit per pound. His slogan, "It's time for the dime," now adorns managers' desks and many line workers' hard hats. "Our industry

STEPHEN VOSS



CEO Pope's goal is to deliver 10¢ of profit on every pound of processed meat

doesn't have a lot of Harvard people," he explains. "You've got to keep the message simple and deliverable."

On that level, at least, the simplicity is working. Last quarter, Smithfield exceeded its goal, making 16¢ per pound on processed pork. But the broader issues of oversupply and flu fears remain.

At the processing plant near Smithfield headquarters, everyone is working flat out. Employees stand bundled up in sweatshirts under their white coats to combat the 45F temperature as they sort hams, bacon, pigs' knuckles, and scraps for hot dogs. Floor-to-ceiling ovens smoke the hams, while bacon is crisped in another room for McDonald's Angus Bacon & Cheese burgers. Technicians monitor the ovens on laptop computers, occasionally leaving their stations to go eyeball the meat. As assistant plant manager Marvin Peterson explains: Any digression "costs us money." |BW|

STRATEGY & COMPETITION

# Wiring America For Green Power

Should the U.S. subsidize high-voltage lines to transport wind and sun electricity to the big cities?

By John Carey

The wind howling over the Great Plains and the unrelenting Southwestern sun pack enough energy to power the entire U.S. with clean, renewable electricity. Trouble is, there's no way to get that power to America's big cities, especially those on the East Coast. As much as 300,000 megawatts of green power, enough to replace more than 300 coal-fired power plants, is being held on the shelf, as it were, because of the lack of transmission lines. This has sparked a movement to create "green power superhighways"—the electrical equivalent of the Interstate highway system. "A high-voltage transmission system will cost a tiny fraction of the money we spent on the highways and do a ton more good," argues Joseph L. Welch, CEO of ITC Holdings, a Novi (Mich.) transmission line developer.

The idea has powerful support in Washington. Senate Majority Leader Harry Reid (D-Nev.) sees an expanded power line system as key not only to tackling global warming but also to creating jobs in Nevada. Now, as the Senate begins deliberation on its climate bill, advocates are pushing to include a national transmission effort, paid for with increases in almost everyone's electric bills.

But is subsidized transmission really a good idea? Ralph Izzo, CEO of Newark (N.J.) utility PSEG, argues that such a system would undermine the development of renewable power. His company is putting solar panels on rooftops and laying plans for wind turbines off the New Jersey coast. Those projects would make less economic sense if cheaper wind energy from the Dakotas came rushing into the Northeast on the new power lines. Creating a transmission system that's largely free to users, on

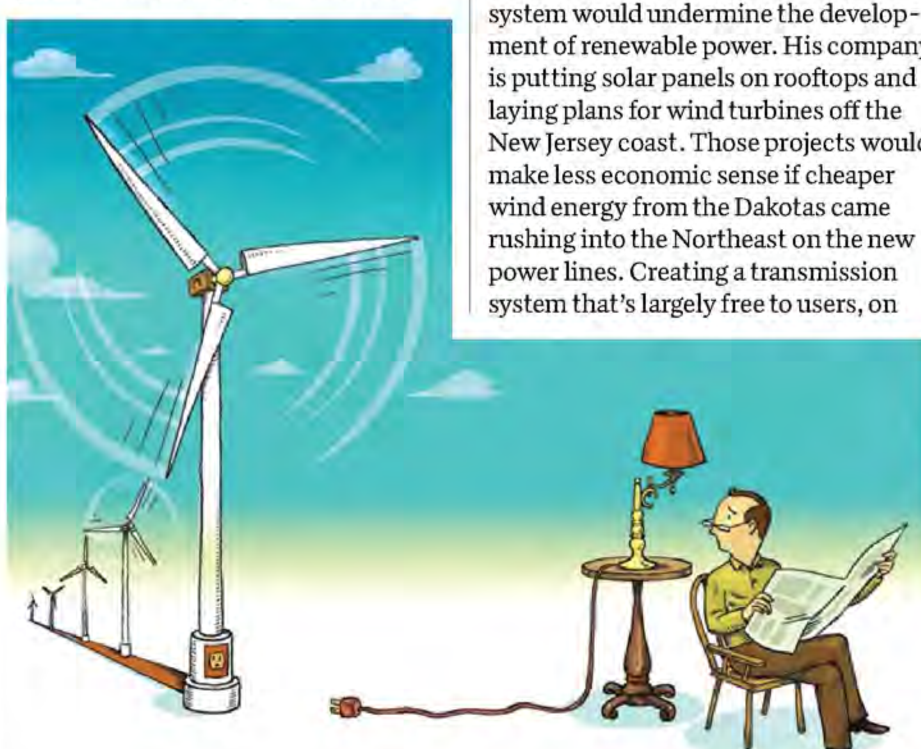


ILLUSTRATION BY WESLEY BEDROSIAN




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the model of Interstate highways, "unfairly biases against the construction of renewables in parts of the country closest to the load," Izzo says.

Worse, say Eastern utility executives like Izzo as well as many environmentalists, many of the power lines built to transport wind energy are destined to travel through coal regions, where any available cheap coal electricity would hop aboard. That would bring unwelcome competition to East Coast utilities—and increase carbon emissions. "There's a very high risk that new transmission development, however well-intentioned, will simply facilitate more of the same old conventional stuff," cautions Environmental Defense Fund analyst Mark Brownstein.

#### BILLIONS IN UPGRADES

At one level, this debate pits wind developers in the West, who need the transmission lines, against such companies as Deepwater Wind in Hoboken, N.J., which is eyeing offshore wind on the East Coast. "I don't want federal tax dollars paying to export jobs to the West," says Deepwater Managing Director Jim Lanard. From a higher vantage, there's a split over the fundamental vision for America's electricity industry. Is it better to emphasize huge wind farms and solar power plants in remote regions? Or should investment first be directed toward boosting energy efficiency, thus cutting the need for power, and toward smaller-scale electricity generation with rooftop solar panels, offshore wind turbines, and other close-to-home efforts?

Whichever side one favors, the status quo is not defensible. "Everyone pretty much agrees that the current transmission system is not built to do this job," says Jon Wellinghoff, chairman of the Federal Energy Regulatory Commission. It's antiquated and inefficient, with 9% of all power generated getting lost in transmission. Billions of dollars of upgrades must be made.

The central question is who picks up the tab for new wires. At one extreme are those who argue that since everyone ultimately will benefit, all electricity users should pay a little extra in their bills, just as everyone pays gas taxes to support highways. Those who oppose such broad subsidies, such as the State of Massachusetts and Northeastern utilities, are looking out for parochial interests, argues Rob Gramlich, senior vice-president for public policy at the American Wind Energy Assn., which is pushing the green superhighway idea. The Eastern states are trying to keep renewable jobs at home, even though homegrown clean energy costs more, he says.

Not exactly, retorts PSEG's Izzo. He wants wind developers in the Great Plains to pay for connecting to the grid, instead of getting a free ride. That "is our economic self-interest," he says, "but it is also aligned with the best interests of the country." Why? Because increasing the costs of renewable developments in the West would create a more level playing field for clean power.

Sierra Club transmission expert Carl Zichella believes careful planning could solve the conundrum. Start by making better use of the existing grid and promoting small-scale renewable generation, he says. Then build whatever new power lines the nation needs the most. Zichella is working on proposals that would sort out competing interests on a regional basis. "It's one of the most important things I have ever worked on," he says. |BW|

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**Green Superhighways?**
Not a good idea, unless your goal is to undercut local efforts, says author John Farrell in an Oct. 19 post to the Grist Web site called "A Little Heresy on Transmission." The counterargument appears in a detailed white paper titled "Green Power Superhighways" on the Web site of the American Wind Energy Assn. Such pipes are the only way to tap the vast wind and solar energy in remote regions, it says.

For these and other stories, go to **http://bx.businessweek.com/green-energy/reference/**

STRATEGY & COMPETITION

# Hobbled by Windows Mobile

Taiwan's HTC is making a splash with its Android handsets, but ties with Microsoft are a drag on profits

By Bruce Einhorn



TAIPEI

These should be fat times for Taiwanese smartphone maker HTC. As cellular operators across the globe rush to introduce handsets using Google's Android operating system, the company is at the front of the pack of manufacturers hoping to supply them. Last year, HTC launched the world's first Android smartphone. Its latest offering—the $180 HTC Hero for U.S. carrier Sprint—has earned upbeat reviews and even outflanked the new iPhone in being named "Gadget of the Year" by British tech magazine *T3*. Soon the world's biggest carrier, China Mobile, will start selling its first HTC-branded smartphones—handsets that can be used for e-mail and the Web—including several Android models.




HTC's $180 Hero, one of its Android smartphones, is getting good reviews

But the erstwhile highflier is struggling. HTC's shares lag far behind the Taiwan benchmark index, and third-quarter profit was off by 18%, its fifth consecutive quarter of sagging earnings. A big part of the problem: For all its Android ambitions, HTC is weighed down by another operating system, Windows Mobile. HTC built its success on Microsoft's offering, and the two companies have cooperated closely.

Today, HTC has the dubious honor of being the world's No. 1 producer of Windows smartphones. While Microsoft may be winning kudos for its new Windows 7 for PCs, phones that run Windows have a reputation for being clunkier than Apple's iPhone, the BlackBerry, or handsets that use Android. Although Microsoft in October introduced an upgrade, Windows Mobile 6.5, that version has underwhelmed many critics.

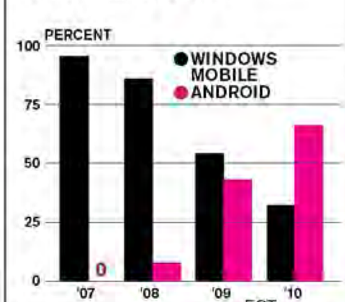
HTC executives concede they have a problem. "Windows Mobile excitement is declining. We know that, and Microsoft knows that," says CEO Peter Chou. Owing largely to the drag from Windows Mobile, the company will see a 20% drop in 2009 earnings, to $700 million, on a 5% decline in sales, to $4.5 billion, Credit Suisse estimates. No wonder HTC is trying to reduce its reliance on Windows. By next year, Deutsche Bank predicts, two-thirds of HTC's smartphones will run Android, up from 8% in 2008.

Still, HTC isn't prepared to admit defeat on Windows and is developing new models. The HD2, for instance, can be easily personalized, with extras such as animated weather updates that adjust automatically based on the user's location. "We feel Microsoft can still deliver products that the customer wants," says HTC Chairwoman Cher Wang. Microsoft says it's not worried and that ever more companies are making Windows phones.

Yet HTC is clearly putting increased emphasis on Android. The company's phone shipments will grow 16% in the fourth quarter, Deutsche Bank estimates, largely because of a 39% quarter-on-quarter increase in Android phones; Windows sales, meanwhile, will be "flattish." Says Erick Tseng, Google's product manager for Android: "We found a really great partner in HTC. They were very eager to take the risk with us to run with Android."

**IN WITH THE NEW**

**HTC's smartphone sales by operating system**




Data: Deutsche Bank

To speed its shift away from Windows, HTC is launching a marketing campaign to build its own brand, which until now has been overshadowed by the carriers that sell its phones. HTC has TV commercials scheduled for the World Series and other high-profile spots, and it has reserved prominent online real estate such as Yahoo!'s home page and YouTube's banner. "It's going to be difficult not to see HTC," boasts Steve Seto, the executive overseeing the campaign. When it comes to the phones HTC makes, though, Windows Mobile is getting harder to spot. |BW|

*—With Olga Kharif and Rob Hof*

CHART BY RAY VELLA/BW





# The Biggest Gamble In Sin City

## As Vegas reels, MGM's colossal CityCenter nears completion—and the casino giant's fate is on the line

By Christopher Palmeri

Every Friday morning, James J. Murren heads to the Las Vegas Strip in his chauffeur-driven SUV to check on the status of his dream project. "Look at that," says the chairman and CEO of MGM Mirage, pausing inside the Aria Resort & Casino. "The marble, the vaulted ceiling—it looks like the Vatican."

Not everyone shares Murren's enthusiasm. Aria is one of four hotels in MGM's CityCenter resort, which will start opening its doors to the public in December. The $8.5 billion development is the debut that every casino manager in Vegas dreads. It will add 4,800 new hotel rooms to one of the country's most saturated markets, not to mention 2,400 condo units and a Cirque du Soleil tribute to Elvis Presley. With luxury rooms in Vegas already approaching roadside motel prices, many worry that the tsunami of fresh supply will drown the city's nascent recovery. And the biggest victim of CityCenter's launch may prove to be MGM itself, which dominates the Vegas landscape with nine other casinos and is staggering under $12 billion in debt.

CityCenter isn't just another real estate development in danger of flopping. It's the largest privately funded construction project in the U.S. and could prove to be a barometer of the health of the overall economy. It's also the ultimate test of a business model that has guided Sin City for decades: that building bigger and flashier resorts will bring ever more visitors and keep Vegas competitive with rival destinations. Even Murren, 47, predicts that "there won't be another property built like this for a long time."

Although advertised as a high-end destination, CityCenter has rooms starting at $129 a night, about $40 less than the lowest rates at competing properties such as the Wynn and the Venetian. "They'll end up cannibalizing themselves," predicts David Baron, a casino analyst at Baron Funds, a major shareholder of rival Wynn Resorts. Vegas tourism is down 6% this year while the convention business has dropped by almost a third. Meanwhile, average room rates are down 25% and casino revenues continue to drop. Matthew Jacob, a gaming analyst with Majestic Research, predicts CityCenter will "prolong the recovery" for practically every operator.

Murren argues that CityCenter's unique attractions could draw a new breed of visitors. Some of the world's top architects are involved in the project, including Daniel Libeskind, César Pelli, and David Rockwell. Sculptures by Henry Moore and Maya Lin line its air-conditioned walkways. As an environmentally friendly touch, MGM will whisk high rollers around in natural-gas-powered limos.

### DOWN ON ITS LUCK

Las Vegas room rates plunged as the number of rooms increased and tourism dropped

| YEAR | ROOMS | AVERAGE RATE | VISITORS (MILLIONS) |
|---|---|---|---|
| 2006 | 132,000 | $119 | 38.9 |
| 2007 | 132,900 | 132 | 39.1 |
| 2008 | 140,000 | 119 | 37.5 |
| 2009* | 150,000 | 92 | 35.5 |

*Estimates for rooms and visitors; average rate is from Jan.-Aug.

Data: Las Vegas Convention & Visitors Authority

### A SCRAMBLE FOR FUNDS

For Murren, who once dreamed of becoming an architect, the project is the culmination of a life goal. After working for 14 years mostly as a casino analyst at what is now Deutsche Bank Securities, Murren joined MGM in 1998. In 2004, as president, he came upon the chance to develop 67 acres on the Strip that contained a parking lot, vacant land, and the low-rent Boardwalk Hotel. Murren wanted to create a development that connected parks, residential towers, and shopping so that guests could feel like they were going someplace new even if they weren't leaving the property. "There are 2 million people in Las Vegas," he says, "and there's been no urban planning."

Kirk Kerkorian, MGM's largest shareholder, was enthusiastic when Murren presented his plans. But then the financial crisis hit. After the banks cut off lending, MGM's 50/50 partner in CityCenter, the Dubai World investment firm, sued to limit its contributions. MGM'S stock fell from more than $16 to less than $2 in the first three months of 2009 as occupancy rates crashed and investors grew pessimistic about the company's fortunes. Murren had to scramble to raise funds to continue construction, including selling MGM's Treasure Island casino and raising $1 billion in a new stock offering. Through it all, he says, Kerkorian reassured him and took the younger man under his wing. He told Murren to make sure to spend more time with his wife and nagged him to get enough exercise to relieve stress. Murren says the 92-year-old investor is convinced that both Las Vegas and CityCenter will thrive.

Yet CityCenter's opening comes at a time when MGM is still vulnerable. The company's cash flow has slid from about $2.4 billion in 2007 to an estimated $1.4 billion this year. With $5.8 billion in debt coming due in 2011, MGM is in danger of default if profits

STEPHEN VOSS



MGM Mirage Chairman and CEO Murren is set to add 4,800 new hotel rooms

slide further, says Michael Paladino, a casino analyst at Fitch Ratings. On Oct. 20 the company took a $1 billion write-off on CityCenter. Kerkorian announced on the same day that he's considering "strategic options" for his 37% stake in MGM. Valued at $15 billion two years ago, his shares are worth $1.6 billion today. Kerkorian said in a filing that he is considering bringing in outside investors to unlock "substantial unrecognized value." Analysts speculate that he may be trying to drum up interest in the company's beleaguered stock, which is now at about $9.60.

#### OLD-SCHOOL VEGAS

The immediate priority is making sure that CityCenter's rooms are filled once it starts opening its doors. In October, MGM sent teams of sales people out to visit meeting planners around the country. Part of their pitch: Vegas is suddenly the great value-for-money destination. Moreover, they're also being told to say, booking an event at CityCenter is good for the economy because the project is creating 12,000 jobs.

Many think the days of $1,000-a-night suites and $400 bottles of tequila are over, with Vegas likely to return to its roots, offering cheap rooms and all-you-can eat buffets. "We were Bargain City, U.S.A.," says William Thompson, a professor of public administration at the University of Nevada at Las Vegas and a longtime observer of the casino business. Timothy Arnold, a meeting planner in Dallas, just booked a group of 150 at the Bellagio next door to CityCenter for $129 a night—with free meeting space. "Vegas is so full of deals now that I'm directing a lot of my clients there."

For MGM, the challenge is to make sure those clients are profitable. Its four-star MGM Grand, down the street from CityCenter, offers $79 rooms with $35 in food credits. Murren says that kind of bargain makes Vegas irresistible: "Doesn't it make you feel lucky?" But Alex Yemenidjian, a former president and COO of MGM who remains close to Kerkorian, says Murren is in a tough spot: "This is the very first time that Vegas finds itself with supply increasing while the market is contracting." | BW |



Holveck sees plenty of room for growth: "The driving element is demographics"

BILL CRAMER/WONDERFUL MACHINE

INNOVATION & TECHNOLOGY

# Testosterone Is Sure Looking Virile

Despite legal setbacks and FDA delays, youth-crazed boomers are making it a billion-dollar industry

By Arlene Weintraub

When Endo Pharmaceuticals acquired two experimental testosterone products earlier this year, CEO David P. Holveck predicted that safety issues might delay approval by the U.S. Food & Drug Administration. Synthetic versions of the quintessential male hormone are prescribed to thousands of patients in the U.S. to treat fatigue, sagging libido, and other signs of testosterone deficiency. But when they're applied as topical gels, they have an unpleasant propensity to rub off on other people—moving, say, from a father to a child and temporarily causing symptoms of puberty, increased aggression, and other annoyances. In addition, the FDA is concerned about the growing use of testosterone by anti-aging clinics seeking to restore youthfulness to baby boomers, and by the abuse of such drugs in sports.

Holveck was right to be worried. On Oct. 19 the FDA said it would not approve Endo's Fortesta, a topical testosterone gel, until the company performs additional safety trials. Only seven weeks earlier, regulators delayed Endo's other product in this class, an injectable version—also over safety issues.

It's no surprise the FDA is being so vigilant. Sales of testosterone products already on the market have rocketed 25% in the 12 months ending in June, to just under $1 billion. The recession has knocked the wind out of other "lifestyle drugs"—medicines to treat conditions that aren't life-threatening. Even Pfizer's blockbuster Viagra fell 8% in the most recent quarter, year over year.

But not testosterone. Boomer lust for the hormone is now spurring a land grab by companies that make it. On Sept. 28 drug giant Abbott Laboratories paid $6.6 billion to acquire Solvay Pharmaceuticals, which makes the leading testosterone product, AndroGel. Auxilium Pharmaceuticals is also angling for market share, and Endo's Holveck thinks there's plenty of room for growth. "The driving element is demographics," he says. Analyst Annabel Samimy, who covers Endo and Auxilium for Thomas Weisel Partners, expects continued double-digit growth for such products, figuring that only 10% of patients who have low testosterone are currently treated.

New entrants in this market, however, will be dealing with a regulatory backlash that began last May. The FDA, having received more than 20 reports of testosterone in commercial products rubbing off on children, required that dreaded "black box" warnings be added to the labels for AndroGel and Auxilium's rival product, Testim. The companies put boldfaced warnings on all their packaging and marketing material, and they had to produce new package inserts instructing patients to wash their hands thoroughly after applying the gels.

The FDA won't say what requirements it will impose on testosterone products that are still under review. But Holveck says the agency wants Endo to do a "washing" study on Fortesta. Patients in the trial will have to clean their hands after applying the gel and then be tested

**$840.7 million**

**U.S. sales of testosterone in the 12 months ended June 30—up 25% from the year-ago period**

Data: IMS Health

to see if residues remain. The requirement will delay approval until sometime in 2010, Holveck predicts.

Testosterone is one of the fastest-growing therapies prescribed by the $80 billion-a-year anti-aging industry, which has embraced it as the cure du jour for andropause, more commonly known as male menopause. Conservative doctors question the existence of such a malady, and testosterone makers shy from discussing it because they're not allowed to promote the drug "off-label"—for uses not endorsed by the FDA. Still, off-label prescriptions are likely to account for much of the market's rapid growth. That fact isn't lost on the FDA: During a press conference to announce the black boxes, an agency spokeswoman said she was alarmed that 25,000 testosterone prescriptions per year are written off-label for women, who use it to boost their libidos.

**BATTLING GENERICS**

The market is so hot that, far from fretting about a regulatory crackdown, testosterone makers are focusing on keeping generic competition at bay. Earlier this year, Auxilium filed a petition with the FDA arguing that the agency shouldn't let a generic version of Testim onto the market without requiring its manufacturer to do washing studies to prove the generic—which has slightly different ingredients—poses no more risk of testosterone transfer than the original. The FDA agreed, freeing Auxilium to concentrate on battling Solvay, which has more than 80% market share, according to researcher IMS Health. In effect, Auxilium turned the agency's growing safety concerns into a strategic coup: It won't face low-cost competitors anytime soon.

Auxilium CEO Armando Anido admits he doesn't have the capital to invest in heavy advertising, as Solvay has done with AndroGel. But he thinks all those Viagra ads urging men to talk to their doctors about erectile dysfunction may be helping him—by fanning interest in products the FDA still views with concern. "Instead of the little blue pill," Anido says, "those men may end up on testosterone replacement." |BW|



# INNOVATION & TECHNOLOGY

BY ADAM ASTON

A photo illustration of FloDesign's wind turbine prototype

**ENERGY**

## A Juiced-Up Wind Turbine

Using features from jet engines, FloDesign Wind Turbine created a compact prototype three times more efficient at turning wind into electricity than today's three-bladed windmills. Two concentric hoops channel air into patterns that create spinning vortexes—like miniature tornadoes—as air exits past the blades. This dramatically boosts air flow. Proponents say the design could transform the wind business in several respects. For example, today's towering turbines require a caravan of tractor trailers to transport them. FloDesign's model fits on a single rig.

What's more, the new design can produce energy at lower wind speeds and in more volatile gusts, making it a natural for spots—such as cities and beaches—that are inhospitable to bigger rigs. In 2008, Kleiner, Perkins, Caufield & Byers committed $6 million in venture capital to the Wilbraham (Mass.) company. FloDesign, which also received funding from the U.S. Energy Dept., hopes to raise an additional $25 million later this year.

**CONSERVATION**

## Nearly Waterless Washing



In the new method, rice-size beads replace most of the water

Hotels, hospitals, and commercial cleaners do tons of laundry every day, leading to outsize utility bills and deluges of wastewater. Now Xeros, a startup spun out of the University of Leeds in Great Britain, is commercializing a process that replaces most of the water with rice-size nylon beads.

Mixed with mere squirts of detergent and water in the rotating drum of a modified washing machine, the pellets act like chemical magnets, absorbing grime and soap as they tumble over fabric. When the wash is done, the beads are automatically collected through an opening in the drum. After a few hundred loads, these get recycled, says CEO Bill Westwater. Lab tests show that the process matches industry standards for cleaning while cutting water volume by 90% and energy use by about 30%. Backed by some $3 million in public and venture capital funds, Xeros aims to sell commercial units by late next year.

# A New Front in The Credit-Card Wars

## Retailers are fighting to get transaction fees reduced—a move that may help them but do little for consumers

By Brian Burnsed

In the latest round of credit-card reforms, issuers and retailers are both playing the consumer-friendly angle. Currently lawmakers are debating whether to cut interchange fees, the tab that merchants pay to card issuers each time a customer uses plastic. While retailers claim they would pass the savings on to shoppers in the form of lower prices, card companies argue the legislation will make credit less convenient and more costly—and they may be right.



Merchants have long complained about interchange fees. They say the costs, which amount to roughly 1.6% of every transaction, erode already razor-thin margins. Last year retailers, the main supporters of three bills now working their way through Congress, forked over an estimated $48 billion in card fees. "We can't keep absorbing these fees," Kathy Miller, a grocery store owner in Elmore, Vt., testified at a congressional hearing in early October.

### CHARGED UP

Retailers are forking over more in fees




*Estimated
Data: National Retail Federation

In their quest to win over lawmakers, retailers maintain consumers won't get hurt—and may actually benefit. "Our market is extraordinarily competitive," says Mallory B. Duncan, general counsel of the National Retail Federation, a trade group. "If costs go down, that tends to drive down prices."

That's not what happened in Australia, though. In 2003 the country's regulators cut the average interchange fee to around 0.5% of the total bill, from 1%. But most retailers never dropped their prices, and credit-card issuers jacked up borrowers' fees to make up for the lost revenue, according to a report by CRA International, a consultancy. After the regulation was passed, the annual fee paid by cardholders rose by 22%, to an average of $25.65. Annual fees on rewards cards jumped by as much as 77% since issuers' profits took a bigger hit. Australian card companies generally levied a higher interchange fee on rewards cards to cover the added cost of the perks—as they do in the U.S.

Analysts worry that retailers and card issuers in the States would respond in much the same way. Already U.S. lenders have been raising rates and tacking on new charges for borrowers following a ban earlier this year from Congress on certain practices, including late-payment penalties. "When the banks have a major source of revenue eliminated, they need to raise [other fees] to make up for that," says David S. Evans, a lecturer at the University of Chicago Law School.

Any new rules could make it less convenient for consumers to opt for credit over cash. As part of the proposals, lawmakers are considering whether to let retailers set a minimum payment for purchases with plastic; they now risk paying a hefty fine for doing so. If such changes are made, customers won't be able to pull out their cards all the time. Merchants may also have the option of rejecting a specific card, like a reward card, if they think the interchange fees are too high. Currently retailers must accept all products under a single brand such as Visa. "Consumers want to be able to use their card for any kind of purchase," says Shawn Miles, MasterCard Worldwide's head of global public policy. The legislation is "anti-consumer."

Such a defense may work. A report by the Government Accountability Office, an investigative arm of Congress, due out by Nov. 19, is weighing the potential impact of proposed rules on the card-carrying masses. If the GAO finds that only merchants benefit from lower interchange fees, card companies may win. Says Brian Gardner, a vice-president at research firm Keefe, Bruyette & Woods: "If the report comes out and says there is little evidence that [the benefits] would be passed on to consumers, then I think the oxygen gets sucked out of this thing." |BW|

*–With John Tozzi in New York*

ILLUSTRATION BY NIGEL BUCHANAN; CHART BY DAVID FOSTER

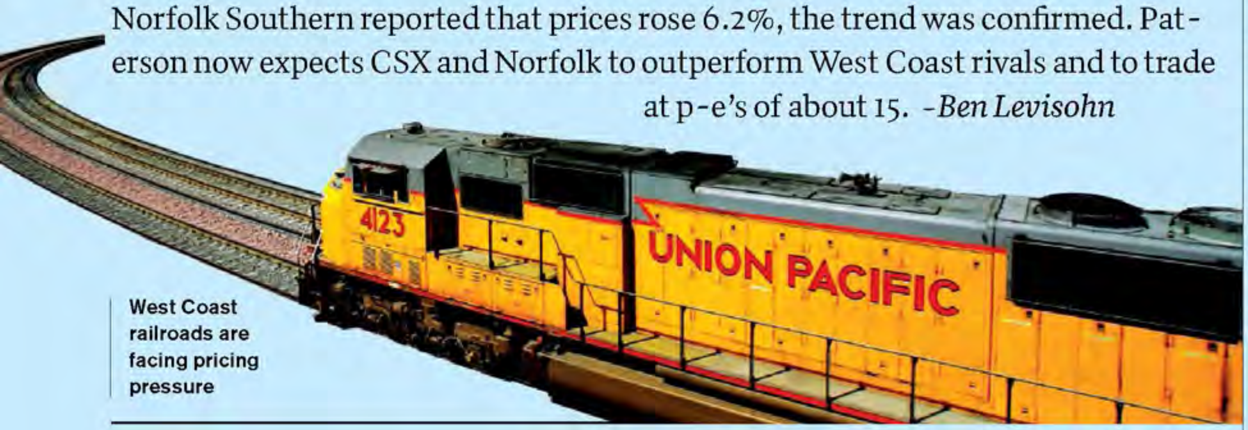
062 How to Play It: Regional banks
064 How to Play It: Junk bonds
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# PERSONAL BUSINESS

MONEY REPORT

## RAILROAD SWITCH

**Union Pacific and Burlington Northern Santa Fe reported better-than-expected earnings on Oct. 23.** But prices rose at a slower clip than in the second quarter at both West Coast companies, creating fears that profits would slip. That drove shares down more than 5%. § Typically, West Coast rails trade at higher price-earnings ratios than East Coast ones. That may change. In this battered economy, pricing trumps all else, says UBS analyst Rick Paterson, and railroads are facing stiff competition from truckers for shipping container business. Since West Coast rails do more of this business, the pricing pressure has hurt them most. Burlington saw its rate of price growth fall from 4% to 3%, and Union Pacific from 5% to 4%. East Coast rival CSX saw no decline. § Since the earnings reports, the East-West valuation gap has narrowed, with Union Pacific and CSX trading at p-e's of 13.7 and 13.3, respectively. On Oct. 27, when Norfolk Southern reported that prices rose 6.2%, the trend was confirmed. Paterson now expects CSX and Norfolk to outperform West Coast rivals and to trade at p-e's of about 15. *–Ben Levisohn*




West Coast railroads are facing pricing pressure

DAVID MCNEW/GETTY IMAGES

M&A

## MEDIA MARRIAGE: BUY NOW?



Independent analysts at Collins Stewart raised their price target for shares of DirecTV Group, which currently trade at 25, to 36 on Oct. 22. The impetus: an announcement that the digital television provider will hold a special shareholder meeting next month related to its proposed merger with Liberty Entertainment, a division of Liberty Media that has a separately listed stock. The analysts say the deal, which is likely to close shortly after the Nov. 19 meeting, should result in a "favorable trading pattern" for DTV's stock. Shares of Liberty Entertainment, which owns interests in Starz Entertainment and the Game Show Network, are also a buy, according to Bank of America Merrill Lynch's Jessica Reif Cohen. She estimates the shares, now at 30, are worth 37. Analysts at Barclays Capital are bullish as well, noting that Liberty is an attractive "way to get the upside potential from DirecTV." *–Tara Kalwarski*

STOCKS

## SEMI SIGNS

**Analysts monitor semiconductor orders carefully for signs of an economic pickup. Jenny Van Leeuwen Harrington, a money manager at Gilman Hill Asset Management in Westport, Conn., also focuses on staffing. So she took note when Taiwan Semiconductor Manufacturing, which reports earnings Oct. 29 and employs 23,000 people, said it planned to rehire 700 employees. That has her bullish on business conditions and Taiwan Semi, which controls half of the global contract chipmaking market. It trades at about 14 times projected earnings for 2010; historically, its p-e has been around 18. Rising chip sales and a 3.5% dividend on the stock's American depositary receipts could bring an 11% to 16% gain next year, she says, which is why she owns more than 62,000 shares.**
*–Lauren Young*

**11%**

**Low end of the 2010 gain one money manager projects for the stock of Taiwan Semiconductor**



# MR. CLEANUP

(FROM PAGE 040)

By Tara Kalwarski

**While the balance sheets of big investment banks are returning to profitability, the financial crisis continues to hammer away at regional banks.** However, the failure of former rivals has enabled some savvy regional players to expand their businesses, and such banks could continue to see market share gains as the economy improves. Among funds that track regional banks, different investment approaches have resulted in vastly different performance figures (below). Portfolios that hold larger companies have notched better records year to date.




Data: Bloomberg, Morningstar, the fund companies

*Data are most recent as of Oct. 26

## THREE WAYS TO GO*

### John Hancock Regional Bank Fund/FRBAX

Expense ratio 1.35%
Holdings 74
Average market cap
$6,577 million

This actively managed fund invests at least 80% of its assets in regional banks and lending companies

### iShares Dow Jones U.S. Regional Banks Index Fund/IAT

Expense ratio 0.48%
Holdings 67
Average market cap
$7,130 million

Small and midsize banks in the Dow Jones Banks Index populate this market-cap-weighted ETF

### SPDR KBW Regional Banking ETF/KRE

Expense ratio 0.35%
Holdings 52
Average market cap
$955 million

This ETF tracks an equal-weighted index, so each holding accounts for about 2% of the portfolio

## RACKING UP RESERVES

These regional banks have increased their number of branches and other retail outlets during the past year, which may give them an advantage as the industry recovers

| COMPANY/TICKER | MARKET CAP (MILLIONS) | PRICE* | P-E RATIO** | DIVIDEND YIELD** | 2009 TOTAL RETURN* |
|---|---|---|---|---|---|
| BB&T/BBT | $17,527 | $25.51 | 15.7 | 5.73% | -2% |
| PNC Financial Services Group/PNC | 23,398 | 50.71 | 19.7 | 4.49 | +6 |
| Regions Financial/RF | 6,060 | 5.10 | N.A.† | 3.54 | -34 |
| U.S. Bancorp/USB | 46,175 | 24.15 | 24.9 | 2.63 | -3 |
| Westamerica Bancorp/WABC | 1,415 | 48.67 | 15.3 | 2.71 | -3 |

Data: Bloomberg *As of Oct. 26 **Calculated using trailing 12-month data †Not applicable because of negative earnings

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To comment on How To Play It stories and see related video interviews, go to businessweek.com/go/09/playit

CHART BY LAUREL DAUNIS-ALLEN/BW

**Simple Truth:** It's important to keep an eye on costs

**Why would anyone pay six times as much as they have to?**




**Many investment firms call themselves low-cost. But, the truth is, many of them charge about six times as much as Vanguard.* This can cost you thousands of dollars. For instance, over 20 years, if you invest $10,000 a year with an average annual return of 8% before expenses, you would keep about $58,000 more with the lower-cost fund!** And the longer you invest, the greater the savings. It's your money. Keep more of it. Vanguard. The simple truth about investing.**

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*Visit www.vanguard.com/simpletruth, or call 800-545-9998, to obtain a prospectus, which includes investment objectives, risks, charges, expenses, and other information; read and consider it carefully before investing.* Investments are subject to market risk. *Source: Lipper Inc. as of December 31, 2008. **Based on 2008 industry average expense ratio of 1.19% and Vanguard average expense ratio of 0.20%. Hypothetical example does not represent any particular investment.

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# ARE JUNK BONDS TOO HOT TO HANDLE?

(FROM PAGE 026)

By Lauren Young, with Tara Kalwarski

**With a flood of new issuance and year-to-date gains averaging 50%, there's worry of a bubble in high-yield bonds.** Rising prices have sent average junk yields from 15% in February to 9% in October. Investors who still want in should proceed with caution and spread their bets.

### CREDIT RATINGS

*INVESTMENT-GRADE*

**AAA** The highest-quality debt; includes Treasuries

**BBB** Can withstand substantial financial stress and still make good on debt

*HIGH-YIELD*

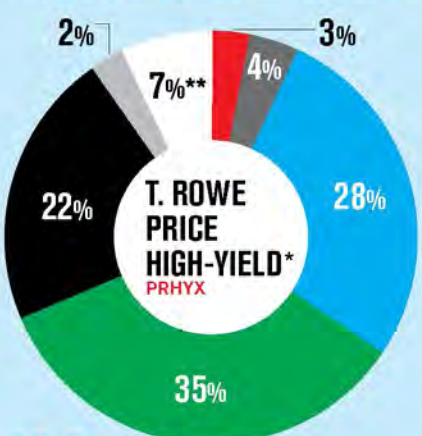
**BB** to **B** The better-rated "junk", but still speculative

**CCC** Near default

**CC** and below ratings signal imminent default

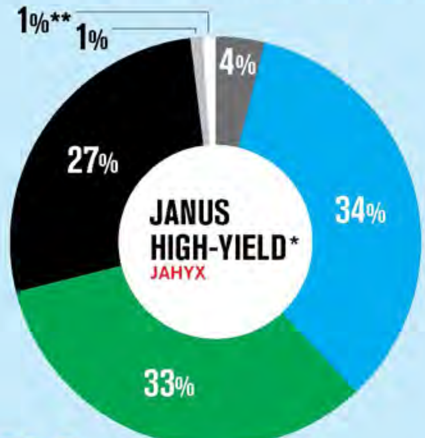
## SLICING UP JUNK

These three mutual funds, which focus on higher-quality junk bonds, have delivered above-average returns over the long run and have low expenses.



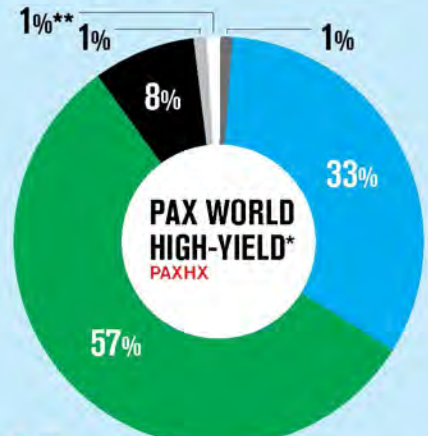

**43.5%** TOTAL RETURN 2009

This fund takes a conservative approach. It has a low expense ratio of 0.80% compared with 1.21% for its peers.
**Current yield: 7.5%**




**36.0%** TOTAL RETURN 2009

The average junk fund lost 26.4% in 2008, but this one fell 19.3%, thanks to its smaller stake in bonds rated below B. It boasts Morningstar's highest rating. **Current yield: 11.4%**



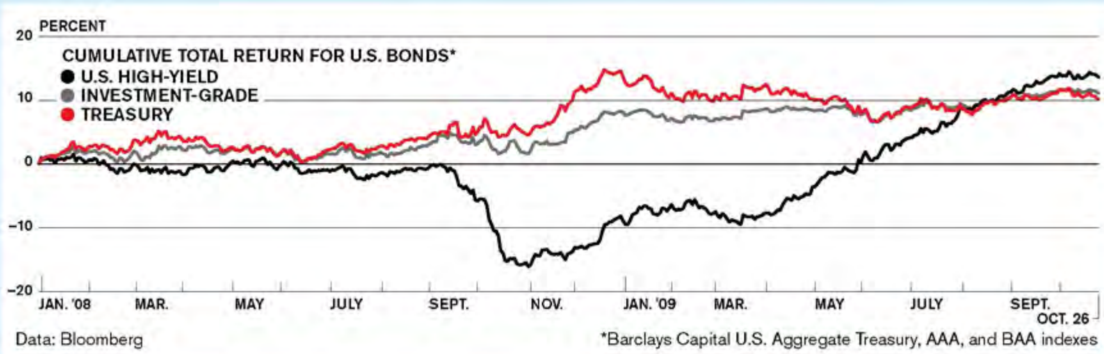

**34.7%** TOTAL RETURN 2009

This fund uses environmental, social, and governance screens. It avoided homebuilders and financials, limiting exposure to the subprime mortgage collapse. **Current yield: 8.6%**

Data: Fund companies, Morningstar *Credit quality ratings are as of Sept. 30; fund returns are as of Oct. 26. Numbers may not equal 100% due to rounding. **White denotes "not rated."

## HIGH-YIELD'S RAPID RISE

After falling off a cliff late last year, high-yield bonds have been climbing back. Their recovery has them outpacing U.S. Treasuries and investment-grade debt.




CHARTS BY RAY VELLA/BW





# CISCO RIDES AGAIN

**At the peak of tech fever in 2000, Cisco Systems (CSCO),** the largest global provider of Web networking gear for transporting data, voice, and video, crested at 82 a share. After the bubble burst, Cisco stock drifted lower for almost a decade, to 13.62 this March. Now it's at 23.02, and some bulls believe the rebound will continue.

### CISCO: ON THE UPWARD TRAIL




Data: Bloomberg

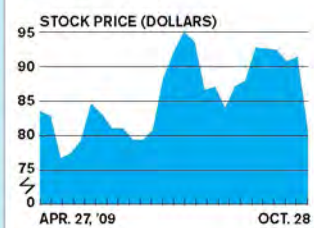
Investors shouldn't ignore Cisco's big role in "riding the wireless-data wave—the surging demand for more data and devices by users everywhere," says Karl Mills, who heads top-ranked Counterpoint Select Fund. Mills believes the number of electronic devices that feed on data will continue to grow. "We invest in companies that gain from this data wave, such as Cisco," he says, which supplies products such as routers and switching devices connecting and managing communications among local and wide-area computer networks. Cisco has also forayed into consumer markets.

Trading at 17 times the fiscal 2010 earnings estimate of $1.30 a share and holding $25 billion in cash net of debt, Cisco is an attractive long-term investment, says Mills, who values it at 30. Matthew Robison of Wedbush Morgan Securities says Cisco's new Net routers "could drive more rapid long-term growth." He has upgraded Cisco to outperform from neutral. For 2011, Robison sees Cisco earning $1.53 a share.

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Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

### PLENTY OF SPICE AT CHIPOTLE




Data: Bloomberg

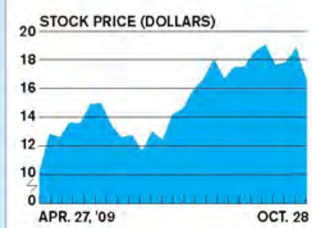
## Lining Up For Chipotle

Some Wall Streeters may not be hot on Mexican food, but investors are ravenous for shares of Chipotle Mexican Grill (CMG). It operates 837 fast-casual restaurants in 33 states serving tacos, burritos, and salads made with fresh ingredients. McDonald's sold its 91% stake in Chipotle in 2006. Chipotle hit 80.17 on Oct. 28, up from 36 last Nov. 21. "We were encouraged by strong third-quarter results," says David Tarantino of investment firm Robert W. Baird (it has done banking for Chipotle), who rates it outperform.

Management projects flat sales for 2010, but Tarantino says this may "prove conservative." He urges investors to "buy into any weakness in the stock." His 12-month target for Chipotle is 115, based on improved restaurant traffic and cost-efficiency.

Dominic Silva of Value Line says the stock is a timely buy and lauds its operating margin of 26%.

### JOHN BEAN GETS ROLLING




Data: Bloomberg

## These Machines Are Humming

John Bean Technologies (JBT), spun off by FMC Technologies in July 2008, is a little-known leader in food-processing equipment and airline ground-support services. John Bean shares are taking off, leaping to 16.40 on Oct. 28, up from 5.85 last Nov. 20.

The company "has a well-established global base of customers, which translates into a big recurring revenue stream," says Al Cardilli of research firm Spin-Off Advisors. John Bean's food processing unit accounts for 61% of sales, and its AeroTech division, which makes aircraft-towing gear among other equipment, generates 39%. Gary Farber of CL King & Associates, rates the stock accumulate and says John Bean's machines sterilize over 50% of the world's canned foods, freeze more than 50% of its frozen foods, and squeeze 75% of its citrus. He expects earnings of $1.03 in 2009 and $1.14 in 2010. |BW|

BRAD TRENT; CHARTS BY DAVID FOSTER

# COUNTRY CLUBS: STUCK IN THE ROUGH

By Dean Foust

**Golf courses across the nation are in crisis as memberships and money dwindle**




From the day it opened its gates in 1998, Superstition Mountain Golf and Country Club was one of the "it" clubs in the Phoenix area. Boasting a Spanish Colonial clubhouse and a pair of Jack Nicklaus-designed courses with majestic mountain views, the club exuded an air of wealth and success. And because Superstition Mountain was the host course for a popular Ladies Professional Golf Assn. tournament, its members got to hobnob with such stars as Annika Sorenstam—a perk that made writing a $100,000-plus initiation check a little easier.

But as the economic downturn suddenly made a club membership seem more extravagance than necessity, Superstition's luck took a turn for the worse. With membership slipping and the developer behind the club and the adjoining residential development suffering his own financial problems, Superstition's lenders foreclosed and now plan to sell the property at auction this December. What happens then is anyone's guess, given that Superstition Mountain has only about half the 780 members originally envisioned. "It's just not feasible that the members take it over at this point," says Keith Bierman, the court-appointed receiver for the club.

For generations of golfing executives, joining a private club not only provided a venue to entertain clients but also served as a validation of their success. Now the economic downturn has created an existential crisis for many of the nation's 4,400 country clubs. To be sure, elite clubs such as Augusta





National, Shinnecock Hills Golf Club outside New York City, and Riviera Country Club in Los Angeles remain impervious to the current downdraft, as do many of the most established, old-money clubs across the country. Hammered hardest are the thousands of middle- and lower-tier courses, as well as many, like Superstition, that sprouted throughout the Sun Belt during the past decade. Already, dozens are in foreclosure. And according to the National Golf Foundation (NGF), as many as 15% of the rest say they're suffering serious financial problems. Among the troubled are such venerable clubs as the Country Club of Lansing, Mich., and the former IBM Heritage Country Club outside Binghamton, N.Y., both of which are in foreclosure.

The pain isn't over, either. The number of golfers belonging to clubs now is down to 2.1 million—900,000 below the peak in the early 1990s. Experts such as consultant Jim Koppenhaver, whose Buffalo Grove (Ill.) firm, Pellucid, monitors the industry, believes at least 400—and worst case, 1,000—private clubs will have to close, convert to public play, or be absorbed into healthier clubs before the carnage is over. "The whole country club model is at risk," says Koppenhaver. But "for a lot of golfers, the value proposition of belonging to a club is hard to pencil out."

While it would be easy to ascribe the clubs' woes to the economic crisis, experts say the seeds were planted in the early 1990s, when Congress enacted tax reforms that eliminated or reduced the ability of club members—and, more practically, their corporate employers—to deduct club dues as a business expense. That raised the effective cost of joining clubs and gave rise to a new breed of upscale public courses some executives view as suitable, and cheaper, places to entertain clients. Societal changes had an effect as well. While earlier generations of men viewed their clubs as weekend sanctuaries from work, if not from the wife and kids, many executives in their 40s and 50s are opting to spend their weekends not on the course but on sports fields coaching their kids' teams.

ILLUSTRATIONS BY BARRY FALLS

**SUDDEN SHORTFALLS**

The clubs themselves share the blame for their plight. Some took on huge loans to fund extensive renovations to courses and clubhouses, racking up debts they are currently struggling to repay. And while 500 of the clubs surveyed by the NGF say they've been running at a deficit, experts believe 2010 could claim even more victims. Most clubs give members a certain window each fall to suspend or shift to a cheaper plan in the coming year, and experts say many are doing just that. "There are clubs that are finding out right now that they're not going to make it next year," says David Shaw, a Greenvale (N.Y.) consultant to clubs.

To plug these shortfalls, troubled clubs are resorting to a



variety of measures. At the roughly 500 clubs that told the National Golf Foundation they were suffering serious financial problems, heavy membership losses were a key culprit. As a result, 90% reported they had tried recruiting new members with discounted initiation fees—and some, such as Inwood Country Club, a 108-year-old establishment on Long Island, N.Y., have waived their initiation charges for golf members. Others are merging with neighboring clubs to cut labor costs, which account for about half the expenses at an average club. That allows the clubs to share the cost of a bookkeeper, food-service director, and other staff. In Cleveland, two clubs facing declining memberships—Sand Ridge and Mayfield—merged three years ago, a move that enabled them to slash overhead enough to keep both courses. But with their combined membership down from more than 700 to 550 in the years since, the renamed Mayfield Sand Ridge Club is entertaining approaches from other clubs looking to merge their way in, too. "We're doing fine, but we're still looking for anything that would help our club," says Jon Outcalt, Mayfield's president.

**TEED OFF**

Despite their best intentions, some of the clubs' efforts to stay afloat have current members grumbling. The offenses include opening the banquet rooms to outsiders and renting the courses for corporate outings and charity events. Not surprisingly, a number of the disputes involve money—and lawyers. At some clubs, members have sued when the clubs dragged their feet on refunding their initiation fees until replacement members are found, a process that can take years at struggling clubs. In Lexington, Ky., seven members of the University Club of Kentucky filed suit in 2003 after club officials slashed the initiation fee from $12,500 to as little as $6,000. That, said members, violated the club's vows that the value of their memberships wouldn't decline. While the club and litigants reached a private settlement, Randolph Addison, a Dallas attorney who specializes in private-club matters, says the courts usually uphold the right of private clubs to alter their fees.

In the end, some industry insiders believe the long-term solution is to reinvent the country club, moving beyond golf to a broader array of services that meet the changing needs of younger members. In San Clemente, Calif., the once-bankrupt Bella Collina Towne & Golf Club has sold 120 new memberships in the past six months by adding pilates, karate lessons, and even a vegetable garden (for the restaurant) that members' kids help plant.

On the golf course, Bella Collina now offers a free junior golf program and permits members to take lessons from the club's instructors at no charge. That last move created turnover among the teaching pros, who viewed the cash from paid lessons as a perk of the job. But club officials say the gesture has helped get more mothers and children out on the course with their fathers. "The country club has to evolve and become like piazzas in Italy, the town square where families—and not just the men who are golfing—meet on weekends," says John G. Fornaro, one of the investors who bought Bella Collina last year. That's good advice, but it may be coming late to clubs where the wolf is already at the door. |BW|

# TO JOIN OR NOT TO JOIN?

## Country clubs are offering sweet deals, but check the details

Joining a golf club has never been more affordable. Many are slashing or even waiving initiation fees. Others are offering trial memberships that allow newcomers to get in for up to three years just by paying monthly dues. But those deals sometimes reflect dire finances, so before you sign on the dotted line:

**REVIEW THE BOOKS**

Clubs must provide members with audited financial statements each year. Ask for copies for the past five years. If the club refuses, that could suggest the problems run deep. If they comply, be wary of operating deficits that might portend a future fee hike or "capital call." Also, check how much income the club gets from outside sources such as renting the ballroom for weddings or the course for corporate outings. Under IRS rules, clubs can't generate more than 15% of revenues from outsiders without putting their nonprofit status at risk. If the percentage is rising—starting to bump against the 15% cap—that could signal shortfalls down the road.

**LOOK AROUND**

Are the fairways spotty, the greens and bunkers losing their shape? Do the electric carts appear overdue for replacement? All are signs the club could be stinting on upkeep to balance its books.

**GATHER INTEL**

Rival clubs are often eager to dish about the competition. Tour nearby clubs, if only to gather intelligence about the one you're looking to join. Does the club churn through teaching pros? Are its fees out of line with the market? Rivals know.

**READ THE FINE PRINT**

Some membership contracts run to 70 pages, but scrutinize them to the end. That could prevent nasty surprises, such as waiting months—or years—to recoup your initiation fee if you ever leave.

**HOPE FOR THE BEST, BUT...**

Some clubs that didn't build up reserves to weather the current storm are imposing capital calls on the remaining membership, either to cover unexpected expenses or service debt. So budget accordingly, in case you're asked to pony up a few thousand on the spot.






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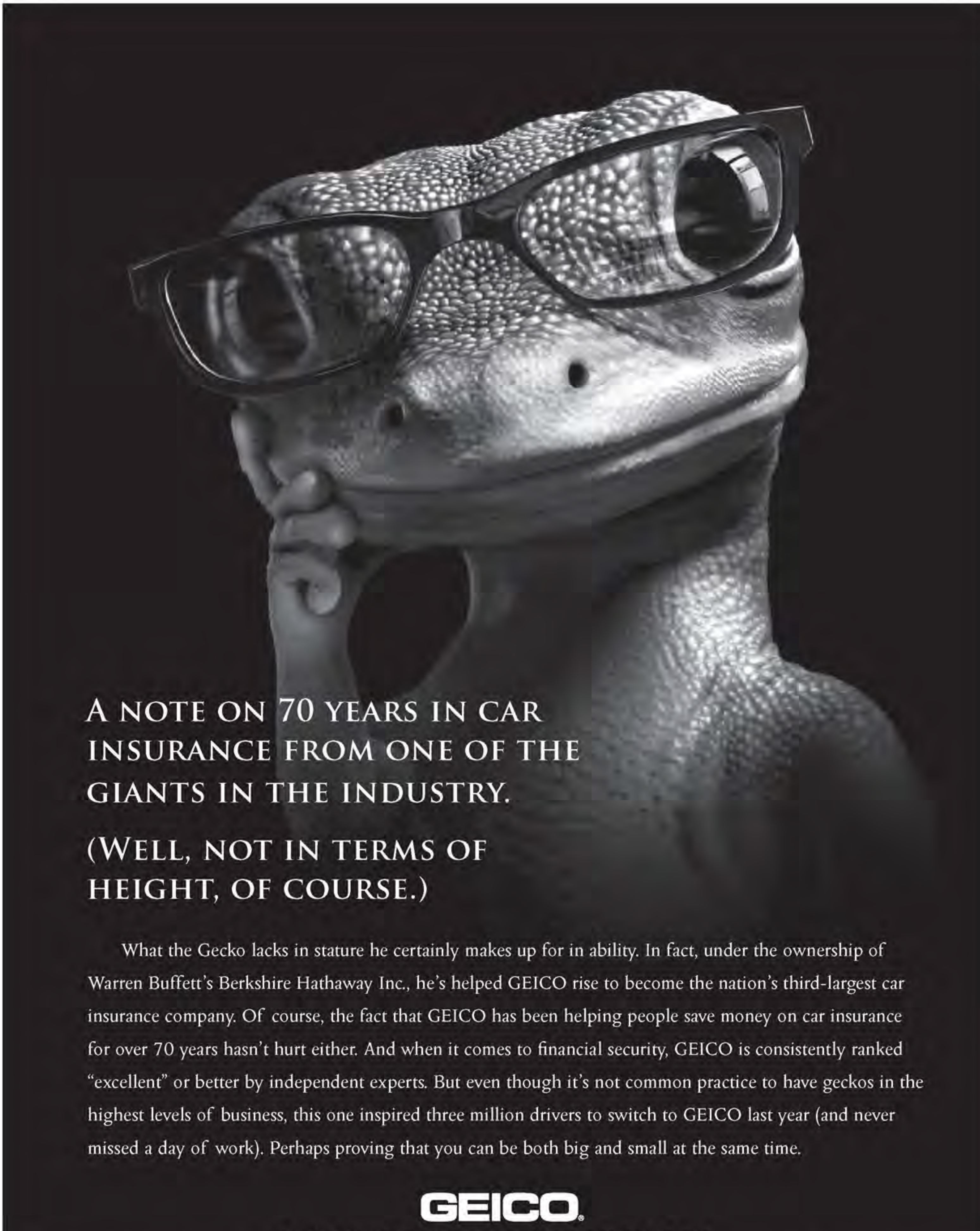
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BOOKS | ADRIENNE CARTER

# An Ambitious Look at Wall Street's Convulsions

**A *New York Times* reporter brings the drama alive with unusual inside access and compelling detail**



MICHA BAR AM/MAGNUM PHOTOS

There's no paucity of books about the financial crisis. Journalists, academics, economists, and pundits seem to have chronicled every event surrounding the drama on Wall Street. Some bite off just a piece, as did *Wall Street Journal* reporter Kate Kelly in *Street Fighters*, which looks at the last three days of failed investment bank Bear Stearns. Others, such as journalist Duff McDonald's biography of JPMorgan Chase CEO Jamie Dimon, *Last Man Standing*, consider a single player's role. And a raft of works chronicle the roots of the meltdown, including the forthcoming *How Markets Fail* by *New Yorker* writer John Cassidy.

But *Too Big Too Fail* by *New York Times* columnist Andrew Ross Sorkin is among the first to tackle the broad crisis, starting with the days after JPMorgan agreed to buy Bear and ending shortly after the government decided to inject tens of billions of dollars into the country's largest banks in October 2008. The book is exhaustive—if somewhat exhausting in its length—and details the fascinating interplay between Wall Street and Washington in the eight critical months that brought the financial system to the brink of collapse.

Sorkin's reporting chops show. He interviewed more than 200 people, spending some 500 hours with top government officials, Wall Street luminaries, and others privy to critical

moments. He also gained access to personal e-mails and confidential documents. Among these is the resignation letter Lehman Brothers CEO Richard S. Fuld sent to the chairman of the Federal Reserve of New York, relinquishing his position on the regulator's board in the days before the investment bank filed for bankruptcy.

As a result, readers feel as though they're in the midst of the action. Sorkin recreates intimate conversations and high-level discussions. For example, the author describes a Saturday morning meeting in July 2008 at the Rye (N.Y.) mansion of Morgan Stanley chief John Mack, during which Lehman's Fuld drops hints about the possibility of a marriage between the two firms. After Fuld departs, a bewildered Mack asks: "Was he offering to merge with us?" Obviously no deal was ever consummated, and Lehman went under just two months later.

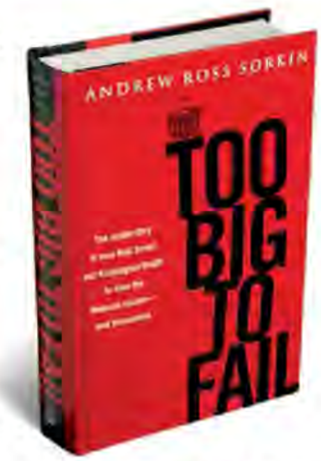
**Those who've followed the crisis closely may not need such detail, but the book could be required reading in colleges**

The author seems to enjoy unusual access to sources. For instance, *Too Big to Fail* contains little-known accounts of how legendary investor Warren Buffett dispensed homespun wisdom to top Wall Street chieftains during critical moments. We read that talks between the Oracle of Omaha and Fuld over a potential investment in Lehman fizzled out in March 2008. Months later, we learn, Buffett sent a four-page letter to then-Treasury Secretary Henry "Hank" Paulson, outlining how the U.S. could buy up banks' toxic assets and make that effective.

Despite its 600 pages, Sorkin's work is highly readable and easily understood. Amid the detailed account of events, he weaves in quirky personal details and amusing anecdotes about the main characters and supporting players. These don't necessarily add a lot of insight, but they do keep the story lively—and make the work appealing to an audience wider than just Wall Street buffs.

In one instance, a longtime colleague of Paulson describes him as having no social skills. The point is later illustrated in a summer staff meeting at the Treasury Secretary's $4.3 million Washington (D.C.) home. When Paulson's wife interrupts the gathering to offer refreshments, Paulson shoos her away, saying "they don't want anything to drink." When she returns with water anyway, nobody takes any for fear of crossing their boss.

These strengths, however, may also be the book's weaknesses. Events are still fresh in the minds of those who have closely followed the financial crisis since 2008—and readers may feel little need for such an in-depth look right now. Some passages may even seem familiar. Sorkin relies heavily on magazines, blogs, and newspapers, including his own reporting for *The New York Times*. The "notes and sources" section runs to nearly 40 pages. There's also plenty of overlap with other accounts of the crisis: Several stories about Lehman, for example, also show up in *A Colossal Failure of Common Sense* by Lawrence G. McDonald, a former vice-president at the investment bank, and Patrick Robinson, co-author of the recent best-seller *Lone Survivor*.




***Too Big To Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—and Themselves*** **by Andrew Ross Sorkin; Viking; 600 pp.; $32.95**

Still, *Too Big to Fail* may have more staying power than other works. It could easily end up as required reading in college history or business courses—once the smoke has cleared a few years from now. **|BW|**

**Business Exchange**

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**TV Broadcaster vs. Print Reporter**

An item on media gossip blog Gawker.com describes a spat between CNBC's Charles Gasparino and *Too Big to Fail* author Andrew Ross Sorkin. In his book, Sorkin writes that Goldman CEO Lloyd Blankfein was "so disgusted with ... Gasparino's 'rumor-mongering'" that he switched off his office TV in protest. Gasparino, whose own book on the financial meltdown is due out Nov. 3, claims Sorkin misquoted Blankfein.

To read the item, go to **http://bx.businessweek.com/goldman-sachs/reference**

TECH & YOU | STEPHEN H. WILDSTROM



# Touch Moves to the Big Screen

**Windows 7 is enabling PC makers to incorporate iPhone-inspired touch features**

Tap doesn't look like the future of personal computing the first time you see it. A mindless little game that resembles an abstract version of Whac-A-Mole, it hooks otherwise rational people into touching colored dots on a screen in order to make them disappear. The dots come fast and furious, forcing you to use all your fingers to keep up —until you suddenly realize your fingers are no longer mere substitutes for a computer mouse. They are the basis for a much more natural way of working with objects on a screen.

Tap, part of a set of applications called Snowflake Suite from Swedish startup Natural User Interface, is designed to show off the capabilities of a new generation of multitouch displays. With the launch of Windows 7, major computer makers are introducing multitouch-enabled versions of laptops, all-in-one desktops, and monitors. I tested touch features on one of the first products to reach the market, the Lenovo ThinkPad T400s (around $2,000, about a $225 premium over a similar model with a conventional display).

Windows 7, like its predecessors, is designed to be used with a mouse and keyboard, and its user interface really doesn't go out of its way to deploy touch as much more than a mouse substitute. But the software includes the ability to handle up to four simultaneous touches and process a repertoire of standard touch gestures including scrolling, rotating, stretching, and shrinking.

By baking multitouch support into the operating system this way, Microsoft has taken a powerful step forward. It has allowed programmers to focus on the creative aspects of new applications, rather than the basics of touch. All developers need to do is reach into the toolbox that Microsoft has provided in Win 7. Building multitouch into the software also means the new apps will all use the same set of gestures, avoiding a huge potential source of user confusion.



BRAD TRENT; ILLUSTRATION BY PETER ARKLE

The makers of touchscreen-equipped PCs also are doing their bit to make the technology useful. Lenovo includes a feature called SimpleTap that provides touch controls for basic functions such as screen brightness and audio volume. Hewlett-Packard has developed a multitouch photo manager, media player, and other apps for its TouchSmart all-in-ones. And Microsoft provides a free Touch Pack for Windows 7 that includes some simple multitouch games and a nifty tool for creating photo collages.

It's going to take a bit of time for software developers to move beyond what are basically demos, but the possibilities are intriguing. The iPhone has already shown the potential for multitouch games, which could be even more interesting on the bigger display of a laptop or desktop. A forthcoming version of SpaceClaim Engineer, a high-end design program, will allow 3D rotation of a model by touching one finger to the point you want to use as a pivot and rotating the drawing with a second finger. Many creative tools, such as photo editing or drawing software, will be greatly enhanced by multitouch.

As is usually the case, hardware advances are going to come ahead of the dazzling software applications. For example, falling prices for multitouch laptop and desktop displays (the former mostly using technology from Israeli startup N-trig, and the latter mainly from New Zealand's NextWindow) are the chief reasons we will soon see multitouch on lots of mainstream PCs, even though applications are still relatively limited.

The advance of touch was slowed for years because software makers were stuck on the idea of using it for mouse replacement and handwriting input. It is now pretty clear that touch won't supplant keyboards and mice for text input, editing, and certain other tasks. But with multitouch displays becoming both good and quite cheap, a major transition will soon be under way. |BW|

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## THE DOLLAR
### CRASH SCENARIOS

Would a crash of the dollar revive U.S. manufacturing? Or make America just another inflation-ravaged nation? And is the chance of a dollar crash so remote that writing about it constitutes trashy journalism? We heard from readers with all three points of view after publishing "What Happens If the Dollar Crashes" (New Business, Oct. 26). The story also prompted a letter calling for replacing the greenback with a single global currency. *–Peter Coy*

There is nothing better than [the] U.S. dollar collapsing.

**Screen name: Good for US manufacturing and US workers!**

What happens if the dollar crashes? We repudiate free trade. We put Americans back to work making things again.

**Screen name: Josiah McGuffog**

The U.S. electorate has demonstrated that, given a choice between sacrificing the entitlements their political leaders have promised them and allowing the Treasury or the Fed to borrow and/or print whatever is necessary to prop up the house of cards, the latter course will always prevail.

**Screen name: ted in pdx**

"What Happens If the Dollar Crashes" looks like the cover of the *National Enquirer*. The dollar is well within [an acceptable] range, given the state of interest rates and GDP. The story failed to mention that no one is betting heavily [on] long-term decline. (See: "futures market.")

**Screen name: Tobby**

Is it time for *BusinessWeek* to consider the future implementation of a single global currency, managed by a global central bank within a global monetary union? As [former Fed Chairman] Paul Volcker wrote: "A global economy requires a global currency." And such a currency can't be managed by one country.



**Morrison Bonpasse**
**President**
**Single Global Currency Assn.**
NEWCASTLE, ME.

## TAX REFORM
### SLIGHTING AMERICAN WORKERS

Regarding "Inside the Business War Against Tax Reform" (In Depth, Oct. 26): Apparently some politicians believe that U.S. multinationals resisting tax reform are representing the best interests of the American worker and economy. I work for one of these companies. It is eliminating higher-paying jobs in the U.S. and Europe in favor of creating jobs in lower-cost areas and using charges against earnings (which lower its effective tax rate) to finance severance packages. If tax authorities want to know what's best for the U.S. worker, they should speak to one.

**Patrick Riley**
CHICAGO

## PRODUCT PLACEMENT
### COMMON SENSE, NOT REGULATION

Free Press, the activist group that is "waging war on product placements," needs to lighten up ("Blasting Away at Product Placement," What's Next, Oct. 26). The McDonald's McFlurry bit on *30 Rock* was a spoof! That show often mocks the use of blatant product placement.

I'm capable of determining the motivations of a show's producers, and I share these insights with my children, who "get" that advertisers are motivated by profit. Thanks for your concern, but I do not need any more FCC protections.

**Bill Spiller**
MARIN COUNTY, CALIF.

## EMPLOYMENT
### NOT HAPPY TO BE 'LOST'

"The Lost Generation" (In Depth, Oct. 19) doesn't offer any advice to young people in search of employment. As a sophomore in college studying business, I am taking advantage of every opportunity—joining business organizations, networking, and applying for internships. I understand that youth unemployment rates are especially low, but this article included no success stories and was discouraging to me and others.

**Sarah Crowley**
NORMAL, ILL.

**CORRECTIONS & CLARIFICATIONS**

"Debt Watch in Dubai" (In Depth, Nov. 2) mistakenly said Abu Dhabi is northeast of Dubai. It is about an hour's drive southwest.

"The App Economy" (Cover Story, Nov. 2) misspelled the name of the founder of tech startup Zynga. He is Mark (not Marc) Pincus.

GARY NEILL

# COMPANY INDEX

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.


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# Jobs Now, Deficit Reduction Later

**The U.S. economy still needs fiscal stimulus. Attack the debt once demand returns**

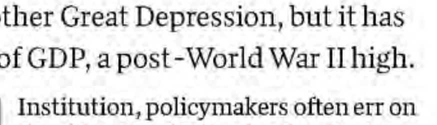
Policymakers in Washington are in a quandary—one that has arisen before at this early, fragile stage in a recovery—over what to do about the federal deficit. An unprecedented amount of fiscal stimulus has been brought to bear to prevent another Great Depression, but it has driven the deficit to more than 11% of GDP, a post-World War II high.

The headline-grabbing size of the deficit makes the case for reducing it a compelling one, and many voters, members of Congress, and investors are convinced that now's the time to strike. According to the most recent Office of Management & Budget estimates, even with a strong recovery, annual deficits will average about 5% of GDP over the next decade, and total debt will climb to nearly 77% of GDP, its highest level since 1952. Persistent deficits of this size will put upward pressure on long-term interest rates, crowding out investment and stunting long-term growth. Interest payments on the debt will be onerous—by 2019 they will exceed defense spending. And investor anxiety about the huge borrowing needs of the U.S. government could trigger a sharp decline in the dollar and another crisis in global financial markets.

As frightening as all that sounds, it fails to capture the immediate challenges facing America. Joblessness is at a 26-year high and rising. And there is a significant probability the country will slip back into recession next year as stimulus spending dies out. Without an economy that's fully up and running, deficit reduction will be a much more difficult task down the road.

Concerns about a double-dip recession have a strong foundation in history. The U.S. economy fell back into recession in 1937 when policymakers throttled back fiscal support too fast, and Japan slid back into recession in 1997 for the same reason. According to a recent study by Alan Auerbach of the University of California at Berkeley and William Gale of the Brookings Institution, policymakers often err on the side of too little stimulus during major recessionary crises. As long as the U.S. economy is operating far below its potential, private demand is weak, and long-term interest rates for government borrowing remain low, continued fiscal stimulus is the wise bet.

The economy is currently caught in a negative feedback loop: Job losses are



causing income losses, which in turn are constraining private demand, reducing tax revenues and causing higher deficits. And for the millions of unemployed and underemployed Americans, joblessness means much more than lost income—it means losses in health care, pensions, job experience and skills, and of course lost homes. It also means dashed hopes for young Americans now trying to enter the workforce. Faced with massive unemployment during the Great Depression, President Franklin Roosevelt made putting people to work his primary task. That should be Job One today, too.

There are several things that should be done soon. Some elements in the current stimulus package should be extended—including unemployment benefits, health-care subsidies for the unemployed, and the provisions for accelerated depreciation and tax breaks to businesses for operating losses. Funds should be channeled into loans for small businesses, as President Barack Obama recently proposed. A National Infrastructure Bank should be created to increase infrastructure financing and encourage public-private partnerships. A new program to encourage energy-efficient retrofits for homes should be designed based on what we learned from the success of cash for clunkers. Obama is holding a meeting with his Economic Recovery Advisory Board to discuss these and other ideas for job creation on Nov. 2. He should cooperate with Congress to get a jobs bill passed—one with triggers that link spending to changes in the unemployment rate—before this session of Congress ends.

Now is not the time to begin cutting the deficit. But it is the time to craft a multiyear plan for gradual reductions in the deficit once the economy is on solid ground. Since fast-rising health costs are a primary source of future deficits, health-care reform with credible cost containment would be an essential first step. And passing legislation soon to spell out a long-term deficit-reduction plan would assuage voter and investor anxieties about runaway debt, ease upward pressure on long-term interest rates, and reduce the risks of another financial crisis sparked by a loss of confidence in the U.S. government and the greenback. |BW|

*Laura D. Tyson is the S.K. and Angela Chan Chair in Global Management at the U.C. Berkeley's Haas School of Business and a former chairman of the Council of Economic Advisers and the National Economic Council.*

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